Central Banking in Sweden and Finland in the Twentieth Century

Jonung, Lars; Haavisto, Tarmo

Published in:
The Emergence of Modern Central Banking from 1918 to the Present

1999

Document Version:
Förlagets slutgiltiga version

Citation for published version (APA):
Jonung, L., & Haavisto, T. (1999). Central Banking in Sweden and Finland in the Twentieth Century. I C.-L. Holtfrerich, J. Reis, & G. Toniolo (Red.), *The Emergence of Modern Central Banking from 1918 to the Present* (s. 111-143). Ashgate.

Total number of authors:
2

LUND UNIVERSITY

PO Box 117
221 00 Lund
+46 46-222 00 00

138. Lars Jonung and Tarmo Haavisto, "Central banking in Sweden and Finland in the twentieth century", chapter 4 in Carl-L. Holtfrerich, Jaime Reis and Gianni Toniolo, eds., *The Emergence of Modern Central Banking from 1918 to the Present*, Ashgate, Aldershot, 1999.

CHAPTER FOUR

Central Banking in Sweden and Finland in the Twentieth Century[1]

Tarmo Haavisto and Lars Jonung

The present central banks of Sweden, the *Riksbank*, and of Finland, *Suomen Pankki*, emerged as a result of a long process. The functions defining a modern central bank such as being a monopoly note issuer, a lender of last resort and a framer of monetary policy evolved slowly over time in Sweden and Finland. Central banking in the two countries displays great similarities, primarily due to an influence from British as well as continental central banking in the nineteenth and twentieth centuries.

As a background to this account, the history of central banking in Sweden and Finland up to 1914 is first described. This year signals the beginning of the end of the gold standard, thus paving the way for a variety of monetary experiments. The chapter then focuses on the policies pursued by the central banks in the inter-war and post-Second World War periods and demonstrates how they were influenced by changing policy preferences and political circumstances. The chapter deals first with Sweden, then Finland.[2]

Central banking in Sweden

The Swedish central bank, the *Riksbank*, is commonly regarded as the world's oldest central bank although it did not accept the functions of a modern central bank until the early part of the twentieth century. It was initially founded as a private bank in 1657 by Johan Palmstruch. Due to financial problems, the private bank was taken over and reorganized by Parliament in 1668. A unique feature of the Swedish central bank is that it has remained the Bank of Parliament since its establishment.

Central banking prior to 1914[3]

The experience of the Palmstruch bank made Parliament aware of the risk of over-issue. The convertibility of the deposits of the Bank – and eventually of its notes – into specie was announced as the prime objective of the Bank when it was set up as the Bank of Parliament. The first paragraph of the Bank's charter of 1668 gave strong guarantees of convertibility and, over the centuries, the legal guarantees for convertibility were extended. As a consequence of repeated failures to maintain convertibility, such guarantees were even put into the constitution of 1809 and remained in force well into the twentieth century.

In spite of these legal rules, the Bank was forced to abandon convertibility a number of times, primarily due to wartime events. The financing of military expenditures during wars could not be carried out through ordinary taxes or lending through capital markets. Lending from the Bank became, in several war episodes, the ultimate way of financing government expenditures.

In this way, Sweden became the first country to experiment on a frequent basis with paper standards. This is demonstrated in Table 4.1 which displays suspensions and resumptions of convertibility, that is the

Table 4.1 Monetary arrangements in Sweden, 1668–1995

Type of exchange rate regime	Period
Fixed exchange rate (copper)	1668–1709
Flexible exchange rate (paper)	1709–1719
Fixed exchange rate (copper)	1719–1745
Flexible exchange rate (paper)	1745–1776
Fixed exchange rate (silver)	1776–1788
Flexible exchange rate (paper)	1789–1803
Fixed exchange rate (silver)	1803–1809
Flexible exchange rate (paper)	1809–1834
Fixed exchange rate (silver)	1834–1873
Fixed exchange rate (gold)	1873–1914
Flexible exchange rate (paper)	1914–1924
Fixed exchange rate (gold)	1924–1931
Flexible exchange rate (paper)	1931–1951
Fixed exchange rate (gold-dollar standard)	1951–1972
Semi-fixed/semi-flexible exchange rates	1972–1992
Flexible exchange rate (paper)	1992–

Note: The exchange rate system 1972–92 encompassed a number of different experiments. Sweden was a member of the European monetary arrangement called the 'snake' until 1977. The *krona* was tied to a currency basket from then on. In May 1991 the *krona* was tied unilaterally to the ECU. From November 1992 the *krona* has been floating.

changes between specie standards and paper standards, between 1668 and 1995. The specie standard was upheld between 1668 and 1709. However, at the news of the Swedish defeat at the Battle of Poltava in present-day Ukraine, in 1709, the Bank was closed, not to open again until 1719. Convertibility was abolished in 1745 as a result of Bank financing of a war with Russia and providing domestic subsidies to various industries. In 1777 a silver specie standard was established.

A paper standard was soon reintroduced as a result of a new war with Russia in 1789. The Bank managed to maintain its independence, however. To circumvent it, the King ordered the National Debt Office, established in 1789, to issue notes. These notes soon replaced Bank notes – demonstrating that an independent central bank is not a sufficient condition for preventing high inflation.

A new silver standard was adopted in 1803, lasting for only six years until Sweden was pulled into a new war with Russia in 1809; a silver standard was not re-established until 1834. In 1873 Sweden switched from a silver to a gold standard which lasted until 1914. The years 1834–1914 were thus the longest period of an uninterrupted specie standard.

The Swedish financial system developed rapidly in the second half of the nineteenth century. One important element of this process was the rise of note-issuing private banks. They soon turned into successful competitors to the note issue of the *Riksbank*. Public and political debate on monetary matters concerned primarily the note issue of the private banks which was resented strongly by many groups. The private note-issue was protected and supported by the executive power against opposition from Parliament which owned the *Riksbank*. In addition to note issuing, there was a similar development in deposit banking. The commercial banking system displayed remarkable growth from the middle of the nineteenth century till the outbreak of the First World War.[4]

The *Riksbank* gradually evolved into a central bank during the pre-1914 gold standard, much influenced by British practices. It learnt the techniques of monetary management primarily from the behaviour of the Bank of England.[5] The *Riksbank* was granted a monopoly of the issuance of bank notes by legislation in 1897. At the same time, it functioned as a clearing house for the commercial banks and engaged in lending to commercial banks by rediscounting. The Bank also phased out its deposit activities. In the crisis of 1907 the *Riksbank* performed a lender of last resort function.

During the specie standard of 1834–1914 the independence of the *Riksbank* was not an issue of debate. The main objective of the Bank during this period was to maintain the convertibility of the *krona*, the new currency unit introduced when Sweden joined the gold standard in

1873. The role of the *Riksbank* changed dramatically with the outbreak of the First World War.

The policy of the Riksbank 1914–31

Sweden moved to a *de facto* paper standard in August 1914 when the *Riksbank* took the unconstitutional step of suspending the gold standard.[6] During the war years the *Riksbank* experimented with several policies. There was a rapid rise in the money stock and in the price level during 1914–20. A heated debate on monetary issues ensued, with the *Riksbank*'s inability to check inflation being a prime target of criticism by Swedish economists. Knut Wicksell, David Davidson, Gustav Cassel, Eli Heckscher and even the young Bertil Ohlin took part in this exchange of opinion. For the first time the governor of the central bank, Victor Moll, became engaged in public discussion on the proper conduct of monetary policy. He argued that the Bank was unable to arrest the rise in the price level. Most economists, however, were of the opposite opinion: a rise in the discount rate of the Bank would hold back inflation.

After the war, the Bank decided upon a return to the gold standard, the first European bank to do so, at the pre-war parity rate to the dollar, first *de facto* in 1922 and then *de jure* in 1924. Most economists were initially in favour of a return to gold at the pre-war rate, that is at the dollar parity rate of 1914. The deflationary experience associated with an extremely high unemployment rate in 1920–22, however, undermined the credibility and acceptance of the gold standard. The economics profession became sceptical of the workings of the gold standard and this paved the way for the monetary programme of 1931.

The inter-war gold standard turned out to be short-lived. When the Bank of England was forced off gold in September 1931, the *Riksbank* followed a week later. The main reason was that the foreign exchange reserves were depleted and the *Riksbank* was unable to obtain any loans from New York, London or Paris.

The policy of the Riksbank 1931–51

On leaving gold in 1931, a monetary programme of price stabilization inspired by Knut Wicksell's theoretical work was adopted by the *Riksbank* and the government. The aim of the *Riksbank* was given as to 'preserve the domestic purchasing power of the *krona* using all available means'. This was a true central bank innovation. The *Riksbank* became the first central bank openly to declare price stability as the target of its policy. The monetary programme of 1931 remained the official basis for Swedish monetary policy in the 1930s.[7]

The Bank lacked knowledge, however, of how to manage a price stabilization programme. Confidentially, a questionnaire was sent to Sweden's most prominent monetary economists at that time, Gustav Cassel, David Davidson and Eli Heckscher, dealing with a large number of issues. The *Riksbank* asked for an immediate reply. The answers became available within two weeks. They gave the Bank clear guidance on a large number of issues and probably influenced the Bank's subsequent policy. A consumer price index was constructed and collected on a weekly basis by the *Riksbank* to use in the implementation of the new monetary programme.

The depreciation that accompanied the decision to leave the gold standard in September 1931 had favourable effects on the performance of the Swedish economy by partially isolating it from the world deflation. During the Kreuger crisis in March 1932, the Bank accepted the role as lender of last resort to the commercial banking system, thus contributing to financial stability.

In the summer of 1933 the *Riksbank* decided at its own initiative to peg the *krona* to the British pound. The pegged rate was in force until the outbreak of the Second World War and, as long as British inflation remained at a low level, the pound pegging was consistent with the programme of price stabilization. However, the pound pegging of the 1930s indicates that the *Riksbank* still had a propensity to adhere to fixed exchange rates.

Ivar Rooth was appointed governor of the *Riksbank* in 1929. Although his position was weakened by the fall of the gold standard in 1931 and the Kreuger crash in 1932, he was not replaced by the new Social Democratic government that came into power in 1932. The *Riksbank* actually remained independent from direct government influence throughout the 1930s although there was an early acceptance of ideas in Sweden concerning more expansionary stabilization policies. These ideas stemmed from the work of a group of young economists later dubbed the Stockholm School. Parliament also made requests for a 'reflation' in the spring of 1932, that is, it asked for a rise in the wholesale price which was not to be accompanied by a rise in the consumer price index. To some extent the *Riksbank* followed this recommendation, at least for a brief period.

The Second World War marks a watershed in Swedish economic policies. It closed Sweden off from the world economy. As an isolated neutral country surrounded by belligerent states, this opened the doors for far-reaching domestic controls. During the Second World War wages, rents and prices were thoroughly regulated by various government agencies. Monetary policy became integrated into the system of controls. The rate of interest was kept at a low and stable level, making ground for the post-Second World War policy of low interest rates.

At the end of the war a new monetary programme, initially prepared by a group of experts, was announced by the government and Parliament. The programme set up three goals for the *Riksbank*: a stable level of interest rates, a stable price level and a stable exchange rate, without any explicit ranking between the three goals. The programme was much influenced by the experience of the deflation after the First World War. Prices could be allowed to fall as a result of improved productivity, that is David Davidson's norm was replacing that of Knut Wicksell. This programme is to date the most recent fully-fledged monetary plan adopted by Parliament as 'owner' of the *Riksbank*.

Events after the end of the Second World War soon demonstrated the inconsistencies of the monetary programme. Sweden experienced a burst of inflation in 1947 and 1948 when the economy was opened up to world markets again and, as a result, the *Riksbank* asked for restrictions on imports. There was upward pressure on the level of interest rates when commercial banks started to dispose of their large holdings of government bonds that they had accumulated during the Second World War.

Meanwhile, a split developed within the Board of the *Riksbank* owing to the request of the governor, Ivar Rooth, for a rise in the level of interest rates. He was opposed by the Social Democrats on the Board and by the Minister of Finance, Ernst Wigforss. Eventually, in the fall of 1948, Ivar Rooth resigned, leaving his post in protest. This was a unique step for Sweden: Rooth remains to this day the only governor who has left after a conflict about the conduct of monetary policy in modern times.

Ivar Rooth was replaced by Klas Böök (governor 1948–51). A most important decision during his term of office was the devaluation of the *krona* in 1949 when Sweden followed the European devaluation relative to the US dollar. The *krona* thereafter kept a fixed rate against the dollar until the early 1970s.

The regulatory regime of the Riksbank 1951–82

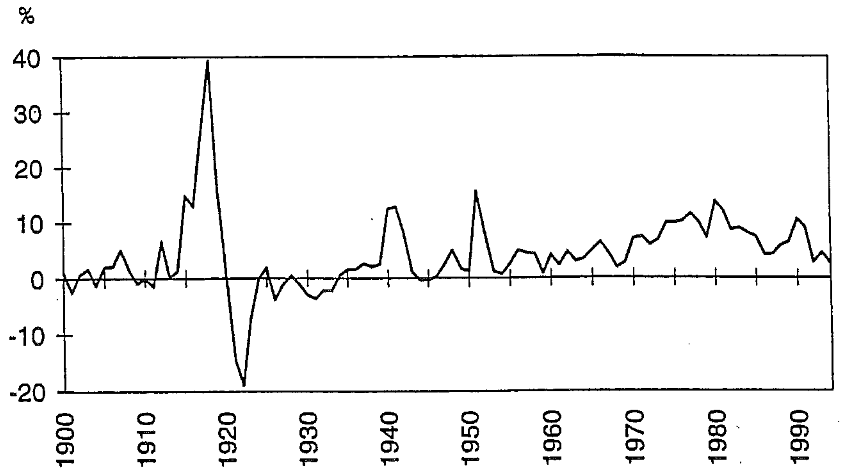
The boom associated with the Korean War contributed to the end of the bond price support programme that had been in effect since the end of the Second World War. In December 1950 the *Riksbank* decided to raise the discount rate. The government requested new techniques of monetary controls that could hold down the rate of interest below the market level. In Autumn 1951, Parliament passed new legislation that encompassed direct controls on lending and deposit rates and the *Riksbank* used this piece of legislation to bargain for 'voluntary agreements' with the commercial banks concerning the allocation of bank loans and the rates charged by banks.

A new policy regime was thus introduced in the early 1950s based on a non-market approach. It lasted for about 35 years. The main goal of the *Riksbank* during this long episode was to maintain low rates of interest, in particular subsidizing the investment activities of the housing sector and the public sector at the expense of other sectors. For this purpose, new monetary instruments were introduced and used, such as liquidity ratios and lending ceilings, primarily aimed at the commercial banking system. It was relatively easy to control the latter because it was highly centralized and dominated by a few large banks. The complete financial system became the subject of close supervision and regulation and financial innovations were actively prevented, Sweden following in this respect the general West European pattern of monetary policies.

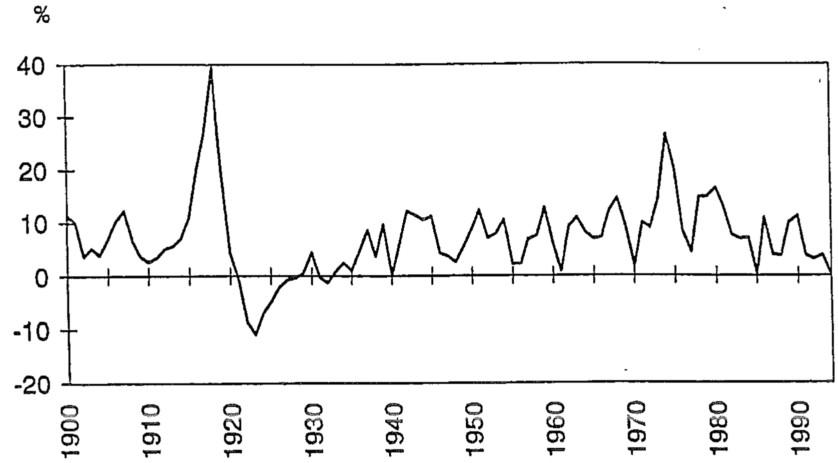
The monthly meetings between the *Riksbank* and various representatives from financial institutions were a central feature of the system of selective credit market regulations. The meetings between the managers of the commercial banks and the *Riksbank* were the most important. They started in the early 1950s and remained an important forum until the deregulation process in the 1980s eliminated their policy role. Here 'open mouth operations' replaced open market operations. At the beginning of the meeting, the assets and liabilities of the commercial banking system as well as of every commercial bank were reported and often commented on. The governor of the *Riksbank* could criticize and threaten commercial banks that did not follow the spirit of the *Riksbank*'s policy. He could also give suggestions and recommendations to commercial bankers present at the meeting. The protocols from the meetings were distributed to the management of all commercial banks.[8]

The price stability goal of the post-war monetary programme was gradually ignored, as can be seen in Figure 4.1. Inflation increased from a low average level in the 1950s to a high one in the 1970s and 1980s. A fixed exchange rate for the *krona*, that is convertibility, was maintained until the breakdown of the Bretton Woods system in the early 1970s, while capital and exchange controls remained stronger than in most other OECD countries during this period.

The demise of the Bretton Woods system and the oil price increases following the OPEC I crisis changed Swedish stabilization policies. The Swedish government initiated an expansionary fiscal policy of 'bridging over' during the OPEC I crisis. This policy was not successful as Swedish exports declined and a trade and a budget deficit arose. The *Riksbank* devalued the *krona* in 1976 and twice in 1977 as a result of the policy of fiscal accommodation during OPEC I. As a consequence of OPEC II



4.1 The rate of inflation in Sweden, 1900–94, in per cent



4.2 Annual growth in the money stock in Sweden, 1900–94, in per cent

a new devaluation was carried out in August 1981. The devaluations of 1976–81 came about in cooperation between the *Riksbank* and the government. The fiscal and monetary accommodation in the 1970s was accompanied by a rise in the inflation rate and by high growth in the money supply, as can be seen in Figures 4.1 and 4.2.

From soft to hard krona *policy to inflation targeting cum deregulation 1982–95*

The Social Democratic party returned to power after the parliamentary election in September 1982. The first step of the new government was to devalue the Swedish currency by 16 per cent – initially the plan called for a 20 per cent devaluation. The devaluation of 1982 was decided by the new government while still in opposition and forced upon the *Riksbank*. This event should be regarded as indicating that the *Riksbank* at that time was considered as the servant of the political majority.

This 'offensive' devaluation came to influence monetary thinking in the 1980s and 1990s, though the 'super-devaluation' was eventually regarded as a large overshooting. There is much to suggest that the Swedish currency was close to an equilibrium rate in the fall of 1982. The nominal devaluation of 1982 was not combined with a real devaluation, that is a switch of expenditures from the public (non-tradables) to the private sector (tradables). Instead, structural (supply side) measures were postponed until the end of the 1980s.

In the 1980s the *Riksbank* was actively pushing for deregulation. Several forces were driving the Bank. The effectiveness of the old system of regulation was being eroded by intermediation outside the controlled 'organized' financial system. The rapid development of financial technologies made it difficult for the *Riksbank* to influence financial flows by non-market-oriented controls. A new generation of policy-makers was entering the Ministry of Finance and the *Riksbank*, who were more positive towards the workings of well-functioning financial markets than the older generations. As the rest of the world was deregulating, it became more difficult for Sweden to stand apart.[9]

Deregulation peaked in the second half of the 1980s. An important deregulatory step was taken in November 1985 when the *Riksbank* abolished existing quantitative restrictions on the volume of commercial bank lending. The outcome was a rapid rise in bank lending when households and firms, previously rationed, expanded their borrowing. The expansion in the volume of credit fuelled a swift rise in the price of assets such as stocks and real estate. In 1988–89 unemployment was around 1.5 per cent. The economy was booming. These years were designated as the period of 'overheating'.

The *Riksbank* did not raise its discount rate out of fear of causing an inflow of capital that would aggravate the boom. In 1989, the last remnants of exchange controls were eliminated. Swedish private individuals and firms became free to invest outside Sweden and immediately started to do so.

Swedish economists in the mid-1980s became highly critical of the soft *krona* policy, that is, the policy of devaluations in 1976–82. It was blamed for the slow growth and high inflation of the Swedish economy. They suggested a move from a soft to a hard currency strategy and the government, the opposition parties and the *Riksbank* accepted the hard currency option – at least rhetorically.

The main objective of the *Riksbank* after the devaluation of 1982 was to turn the *krona* into a hard currency. Actually, there was some discussion of tying the *krona* to the *D-mark* in late 1982. A fixed exchange rate became the main goal: the devaluation of 1982 was to be regarded as the last one. However, this policy failed eventually when the boom of the late 1980s was followed by a bust in the early 1990s.

The Swedish economy peaked in 1990. The asset price inflation of the late 1980s was followed by an asset price deflation with real rates of interest rising sharply and inducing households and business to reduce current expenditures and increase financial savings. The stock market and the real estate market plummeted. The budget deficit exhibited an explosive rise. By 1992 the Swedish economy was in the most severe recession since the 1930s.[10]

In May 1991 the *krona* was tied unilaterally to the ECU.[11] As events unfolded, this step implied a minor but unexpected appreciation of the *krona*. After the 'No' vote in the Danish Maastricht referendum, the *krona* came under increasing speculative pressure. In September 1992, the *Riksbank* carried out a stubborn defence of the *krona*, using for a short time overnight rates of 500 per cent but the attempt to switch from a soft to a hard *krona* failed. In November 1992, the *Riksbank* was forced to let the *krona* float.

In January 1993 the Bank announced an inflation target. Starting from January 1995 the aim of the Bank is to hold the rate of consumer price inflation at 2 per cent per year plus/minus one percentage point. It is too early to tell how successful the inflation targeting of the *Riksbank* will be. So far it appears to have worked well. The Swedish inflation rate has remained close to the targeted level, actually rather below than above it, thus contributing to enhanced credibility for the programme.

The independence of the Riksbank

As long as Sweden adhered to a specie standard, that is to the gold standard, the independence of the *Riksbank* was not an issue. Monetary policies were designed to maintain full convertibility of the *krona*. The room for monetary politics was minimal under this institutional arrangement. Monetary policy was thus not a part of the political process. In the 1930s, following the fall of the gold standard, the independence of the Bank became a subject of discussion among economists, initially, however, with no consequences for the legal framework of the Bank.

In the post-Second World War period the relationship between the *Riksbank* and the government, and thus the independence of the *Riksbank*, changed character twice. First, with the advent of the regulation of the financial markets, the political system was given an opportunity to influence the allocation and the price of credit flows within the Swedish economy through the *Riksbank*. The *Riksbank* felt obliged by political pressure to maintain interest rates below the market clearing level. In this process it became subordinated to the Ministry of Finance. The *Riksbank*, at least judging from some statements by one of its governors in the 1950s, did not appreciate this role. It wanted to remain free from pressure by the Ministry of Finance.

Second, as a consequence of the financial deregulation in the 1980s, the *Riksbank* gradually gained a more independent position towards the Ministry of Finance. The goal of the *Riksbank* became solely to maintain a fixed rate for the *krona*, abdicating from the role of directly controlling interest rates and the flow of credit.

The Social Democratic party ruled Sweden from the election of 1932 until the election of 1976. The dominance of this party meant eventually an increase of the power of the political system over the framing of monetary policies and thus over the *Riksbank*. As a socialist party it was highly critical of the workings of private commercial banking and a private financial system. Nationalization of commercial banks was a regular demand at the party conferences until recent times.

Ivar Rooth's exit in 1948 as governor of the *Riksbank* signalled the rising influence of the Social Democratic government over the framing of *Riksbank* policies. The executive power controlled the Bank through the appointment of the governor and of the chairman of the Board of the *Riksbank*. The Board was composed of members of the Parliament reflecting the political balance in Parliament. The majority party or parties thus held a majority on the Board as well. The chairman of the Board was as a rule the under-secretary at the Ministry of Finance.

After Ivar Rooth's departure the Social Democrats as the ruling party controlled the governorship until 1976. This meant a break with a past during which new governors, as a rule, had experience gained in positions in the financial system. The Social Democrats appointed governors, often with a background in Social Democratic politics. Still, this could not prevent a major clash between the *Riksbank* and the government in 1957. The Board of the Bank raised the discount rate without first informing the government, that is the Minister of Finance. This step caused a major political reaction and debate about the independence of the Bank. The chairman of the Board, actually a

Social Democrat, was forced to leave, to be replaced by another Social Democrat.

The power of the Minister of Finance over the *Riksbank* can also be seen from a series of interviews of former policy makers within the *Riksbank*. These interviews bring out the close contacts between the *Riksbank* and the Ministry of Finance, with the *Riksbank* consistently asking for tighter fiscal policies and the Minister of Finance asking for lower rates of interest, that is for low discount rates, or at least no hikes (Jonung, 1996). It is clear from these interviews that the *Riksbank* felt pressure from the Ministry of Finance concerning the conduct of its policy and was ready to listen to the arguments of the Minister. On the other hand, monetary policies during this period were geared towards maintaining a fixed exchange rate for the *krona* which reduced the room for discretionary measures not consistent with external balance.

The term of office for the governor of the *Riksbank* coincided with the election period. Thus, after every election to Parliament, the government had the opportunity to appoint a new governor of the *Riksbank*. In 1976 the Social Democratic party lost an election for the first time in the post-war period. The new government tried to convince the governor of the Bank, a former Social Democratic minister, to remain in office. However, at the request of the leadership of the Social Democrats he resigned. When the Social Democrats returned to power in 1982, they replaced the governor with Bengt Dennis, one of their own.

The term of office of the governor of the *Riksbank* was changed in 1989 in such a way that it did not coincide with the elections to Parliament.[12] This meant that after the election of 1991 when the Social Democrats were again forced out of office, Bengt Dennis remained as governor of the *Riksbank*. He left in 1994 to be replaced by Urban Bäckström, a former conservative under-secretary at the Ministry of Finance, an appointment of the non-socialist government.

After the victory of the Social Democrats in the election of 1994, there was some uncertainty about the position of governor Bäckström. It turned out that he stayed in office. This should be regarded as a step towards a more independent *Riksbank*, although the debate about the relationship between the *Riksbank* and the government continues. There is still a highly sceptical attitude, in particular among union representatives, towards an independent *Riksbank*.

Swedish economists, influenced by the inflationary experience of the 1970s and 1980s, as well as by international developments, have been arguing for a more independent *Riksbank* in order to create an incentive structure less prone towards inflation. This view has gained support primarily among the non-socialist parties. It led to reforms of the legislation concerning the *Riksbank* in the late 1980s. Additional legislation to increase the independence of the Bank has been put forward in the 1990s to adjust Swedish central bank legislation to the European pattern in case Sweden wanted to join EMU.

Without doubt the Bank is now more independent from the executive than earlier in the post-Second World War period. The Board has fewer members taken from Parliament. The chairman of the Board is no longer directly associated with the Ministry of Finance. The present chairman is openly arguing for more independence. It is an irony that the push for an independent *Riksbank* is motivated by some proponents by Sweden's membership in the EMU. Before abolishing the world's oldest central bank, it is necessary first to make it independent from the executive power.

Is there an election pattern in the policy of the Riksbank?

The concept of central bank independence is a complicated one. One aspect concerns the room for short-run manipulations of monetary measures. An independent central bank is not supposed to engage in such activities. Considering the strong position of the Ministry of Finance towards the *Riksbank* in the post-Second World War period, there are reasons to suspect that the behaviour of the *Riksbank* was influenced in a systematic way by the timing of elections to Parliament.

This issue has recently been studied by testing several reaction functions of the *Riksbank* including a dummy variable for parliamentary elections (Frennberg and Jonung, 1996). These tests do not lend support to there being a consistent election pattern. However, in some cases it cannot be ruled out that the *Riksbank* was influenced by an upcoming election.

The *Riksbank* thus appears to have been independent in a short-run stabilization policy perspective. In the long run, however, it has been forced to carry out the policy of low rates of interest and selective credit and capital controls. The lack of an election pattern in monetary policies is thus not inconsistent with the view that the Bank had been the long-term servant of the Ministry of Finance prior to the financial deregulation of the 1980s. Once the financial markets were deregulated, however, the *Riksbank* no longer had the ability to control the level of interest rates and the allocation of credit. Instead, the policy of the Bank now requires the existence of well-functioning financial markets. This suggests that the independence of the *Riksbank* relative to the Ministry of Finance has been fostered by the development of efficient capital markets.

Central banking in Finland

Historical background

Finland and Sweden share a long common history. Finland was joined to Sweden from the twelfth century, until it was annexed to the Russian Empire, in 1809, as a result of the Napoleonic wars. During the nineteenth century, Finland was an autonomous grand duchy of the Russian Tsar. During this period, until 1917, when Finland declared its independence, the old Swedish constitution, as well as fundamental parts of Finland's legal, administrative and religious institutions that were in force under Swedish rule, remained intact. The autonomy of Finland was reinforced by the maintenance by the Finnish central bank of its own currency, the *markka*. Fiscal policy, economic legislation and the state finances remained under the control of the Finns.

The first precursor of the Bank of Finland, called *Åbo Diskontoverk*, was in operation between 1806–1808. As a result of the Napoleonic Wars and the separation of Finland and Sweden, the *Åbo Diskontoverk* was dissolved and was later, in 1811–12, succeeded by the *Vaiheitus-, Laina- ja Depositioni-Contori Suomen Suuren-Ruhtinanmaasa* (the Exchange, Loan and Deposit Office of Finland). This precursor of the Bank of Finland had little resemblance to a modern central bank. It did not conduct monetary policy, nor did it regulate or support the banking system. It did not even have the right to issue its own notes.[13]

In the first half of nineteenth century two different currencies were circulating in parallel in Finland. The Swedish currency, which had been traditionally used in Finland before 1809, circulated at least until the 1840s in large amounts. The second currency was the *rouble*, which was introduced after Finland was annexed by the Russian Tsar in 1809. The first notes denominated in the Finnish currency, the *markka*, were issued by the Bank of Finland in 1860. Initially the value of the Finnish *markka* was directly tied to Russian paper money. In 1866, the Finnish monetary system was separated from the Russian *rouble*, when the *markka* was put on the silver standard. The Finnish silver standard lasted for 11 years from 1866 to 1877. After Denmark, Germany, Norway and Sweden had adopted the gold standard in the early 1870s, the Bank of Finland wanted to follow suit. This transition of the *markka* to gold implied a further separation of the Finnish monetary system from the *rouble* system. Finland adhered to the gold standard during 1878–1914, that is for 36 years.

During the next 36 years, Finland experienced several monetary arrangements: 1914–26, the First World War paper standard; 1926–31, the inter-war gold standard; 1931–32, the inter-war paper standard;

Table 4.2 Exchange rate regimes of the Finnish *markka*

Period	Regime	Value
1865–1877	Silver standard	Fixed, 1 FIM = 4.44987 grams of silver
1878–1915	Gold standard	Fixed, 1 FIM = 2.9032 grams of gold
1915–1925	Paper standard	Floating
1926–1931	Gold standard	Fixed, 100 FIM = 3.7894 grams of gold
1931–1932	Paper standard	Floating
1933–1939	Sterling	Fixed, £1 = 227 FIM
1939–1949	Dollar	Floating (in 1939: $1 = 49.35 FIM)
1949–1971	Bretton Woods	Fixed, devaluations 1949: $1 = 231 FIM 1957: $1 = 320 FIM 1967: $1 = 4.20 FIM*
1971–92	Paper standard 1971–91: Pegged to a trade-weighted currency index 1991–92: Pegged to the ECU	Fixed (pegged) devaluations 1977–78: 18% 1982: 10% 1991: 12%
1992–	Paper standard	Floating

* Currency reform in 1963: 100 FIM (old) = 1 FIM (new).

Source: Elonen (1992) and Autio (1992).

1933–38, the pound standard; 1939–50, the Second World War paper standard (see Table 4.2). Although the monetary system in force changed several times during this period, monetary thought and policy were greatly influenced by the experience of the classical gold standard. In 1948, Finland became a member of the IMF and the par value of *markka* was confirmed three years later in 1951. Finland participated in the dollar gold standard until the collapse of the Bretton Woods system in 1971. Since 1972, the Finnish currency has been a paper currency and from 1973 until the early 1990s the foreign value of the *markka* was pegged against a basket of currencies most important to Finland's foreign trade.

The regulation of financial markets has been of great importance for the structure of banking in Finland and has constituted a principal instrument of monetary policy. Consequently, this section will examine the regulation system in some detail and offer a chronological overview of the history of regulated money in Finland.

Historically, the structure of Finnish capital markets has had four cornerstones: (1) the central bank, the Bank of Finland, as a 'market maker', (2) large deposit banks, (3) isolation relative to foreign capital, and (4) regulation of the domestic actors. The Bank of Finland has been heavily involved in all these fields that characterize the Finnish financial system and, thus, the history of money and banking in Finland is, to a large extent, the history of the Bank of Finland.

The legal framework

From 1809 to 1917, a period in which Finland was a Grand Duchy of the Russian tsar, many of the old Swedish laws and constitutions from the former Swedish rule remained in force.[14] When the precursor of the Bank of Finland, *Vaiheitus-, Laina- ja Depositioni-Contori Suomen Suuren-Ruhtinanmaasa,* was established by an act of the Tsar, in 1811, the estates of the realm in Finland expressed a wish that this bank could be established in the Swedish manner as the Bank of the Diet. However, the Russian Tsar decided not to take any notice of these wishes and the bank came to be controlled by the Russian Crown and the Finnish government, known as the Senate. The Board of Governors had three members, the senior member of whom was the Chairman of the bank. Until 1840 the main purpose of this bank was to carry out a currency reform through which the Swedish currency would be replaced by the Russian *rouble.*

Prior to 1840 the currency system in Finland was rather chaotic; both Swedish and Russian species as well as Swedish and Russian notes circulated. The paper *roubles* issued by the precursor of the Bank of Finland were of minor importance. In 1840, after both Russia (1839) and Sweden (1834) went on silver, monetary conditions improved. A currency reform was put in force and the authorities finally succeeded in replacing the Swedish currency by the silver-*rouble*, which was now issued by the Bank of Finland.

During this period, the Bank of Finland introduced several activities which appeared important for the subsequent development of the Finnish payment system. New branches were established in the countryside and new contacts with foreign banks were established (St Petersburg and Hamburg). Although the Bank of Finland was still the only commercial bank in the country, important steps were taken for its subsequent role as the Finnish central bank. From 1840, the Bank of Finland had responsibility for the functioning of the Finnish payment system, but with regard to monetary policy the Bank was subordinated to the economic department of the Finnish Senate, that is the government.

The direct tie between the Finnish and Russian *rouble* became fatal during the Crimean War of 1854–56. When the Russian *rouble* went off the silver standard, Finland had to follow suit and returned to a paper standard. In 1860, the Finnish government succeeded in getting the Tsar's approval for a new monetary unit in Finland: the *markka* divided into a hundred *pennies*. The Finnish *markka* remained tied to the Russian *rouble* with an exchange rate of four *markka* to one silver *rouble*. The heavy fluctuations of the Russian *rouble* delayed the adoption of the silver standard, and it was not until 1865 that the Finnish government placed the *markka* on silver.[15] According to the 1865 monetary reform, both the new silver-*markka* and, within certain limits, the silver-*rouble*, were to be the only means of payments in Finland. This reform separated the Finnish monetary system from the unstable Russian *rouble*.

Parallel to the currency reform, another important reform was undertaken. Under a decree of 1867, the Bank of Finland was placed under the control and supervision of the Finnish parliament. A Parliamentary Supervisory Board was instituted, composed of one member of each of the estates, the chairman of which could directly control the Bank and the central bank policy in Finland. The Governor of the Bank was still appointed by the Tsar, but the Board of Management was supervised by the parliamentary board. This system, whereby the Governor of the Bank is appointed by the head of the state while the supervisory board is appointed by Parliament, is still in force.

A further step in separating the Finnish currency system from the Russian system occurred in 1877–78, when Finland adopted the gold standard. While Finland went onto gold, the monetary instability in Russia prevented the *rouble* from doing the same and thus it was possible for the Finnish authorities to liberate the *markka* from its remaining ties to the *rouble* as a parallel currency. It was the first time when the characteristic features of Finnish central banking were fulfilled: (1) the central bank was under the supervision of the Parliament (the estates), (2) central bank policy was outlined by the Parliamentary Board, and (3) monetary policy was defined primarily in terms of the external value of the *markka*, the gold value of the *markka*.

The decree of 1867 was successively modified in 1875, 1878 and 1890. The main changes occurred in 1875, when the role of the Bank of Finland as monetary authority and bankers' bank was accentuated by a decree which stated that 'the object of the Bank of Finland is to maintain a stable and secure monetary system, and to assist and facilitate the circulation of money in Finland'. Furthermore, the government's monetary transactions were removed from the Bank of Finland to a new authority, the State Treasury. The other modifications did not imply any fundamental changes in the rules and regulations of central banking: these modifications included changes in the conditions of the note issue, the number of members in the management board, ceasing the payment of interest on deposits and so on.

Two major banking laws essentially shaped the bank system before the First World War. The first one dates from 1866 and the second from 1886. The first banking law was established only some years after the first commercial bank, *Suomen Yhdyspankki*, was founded in 1861–62. It regulated the minimum size of the capital stock, the share of foreign participation, reserve fund requirements and the right of note issue. Furthermore, the banks were placed under the supervision of the government and the supervisory authority had the right to investigate banks at any time.

The regulations applying to the minimum capital stock and to the commercial bank note issue were significant factors governing the development of the Finnish banking structure. The capital requirement was so high that it was difficult to meet it out of local funds. Accordingly, the minimum capital stock requirement contributed to the development of a commercial banking structure that consisted of a few, relatively large banks with country-wide operation. The commercial bank notes did not circulate in any large amounts during the period of this banking law. The main reasons for this were partly the limits on the total volume of note issue and partly the high face value of the notes.

The banking law of 1886 eased capital requirements and accordingly removed the restriction to establishing smaller provincial banks. The result was that many smaller banks were established after 1886, mainly in Helsinki. However, the banking structure remained the same with the dominance of a few, nation-wide banks. One other major change was that the right of note issue for commercial banks disappeared as a result of the 1886 law and the earlier *de facto* central bank monopoly on note issue was now confirmed by legislation.

After independence in 1917, the formal standing of the Bank of Finland was confirmed by the constitution of Finland. According to the constitution (Constitution Act 1919 and Parliamentary Act 1928), the Bank of Finland 'operates under the guarantee and care of Parliament and is supervised by the Parliamentary Supervisory Board'. The Governor and the members of the Board of Management were appointed by the President of the Republic for an indefinite period of time. Furthermore, the constitution stated that 'parliament decides on the disposal of profits of the Bank according to the needs of the State'. Under the Currency Act (1926, 1962), the bank has the exclusive right to issue notes.

The environment of central banking has changed several times during the past decades. The most recent changes are the deregulation of interest rates, the liberalization of capital movements and international integration. However, the legislation of the Bank has not required any major changes. It appears that although the relationship between the financial markets and the central bank has experienced remarkable changes, those changes have not required any fundamental changes in the rules of monetary policy decision making, which have remained more or less the same during the twentieth century.

The Bank of Finland has a high degree of independence from the government. The Parliamentary Supervisory Board has mainly supervisory duties but also monetary decision-making authority in certain key matters such as the conditions for foreign and central bank borrowing. The Board of Management decides all matters which have not been expressly entrusted to the Supervisory Board: interventions on the money and foreign exchange markets, interest rates on overnight loans, minimum reserve requirements and foreign exchange regulations.

The only monetary decision directly made by the government is the fixing (or the changing of the limits of fluctuations) of the external value of the *markka*. The government can either approve or reject a proposal on these matters made by the Parliamentary Supervisory Board upon the recommendation of the Board of Management. The Finnish Parliament, in turn, participates in monetary policy through legislation and through the selection of the members of the Parliamentary Supervisory Board. This selection is based on relative party representation in parliament, which implies that the coalition making up the government also has a majority on the Supervisory Board.

The members of the Management Board are highly independent of the government and as long as a major part of monetary decision making is vested in the Board, the position of the central bank will remain strong.

The early stage of central banking in Finland

In 1857/58 an 'active' interest rate policy was applied by the Bank of Finland for the first time (Pipping, 1961: 295–6; Pipping, 1969: 146–7). Since 1840 (the starting year for the discounting of bills), the discount rate had been constant at four per cent. In 1858, with the aim to reduce the foreign trade deficit, the discount rate was increased in stages and regulations were applied to both foreign currency and central bank credits. Also, after the recession of the 1870s, the Bank of Finland decided upon an active interest rate policy to stimulate the domestic economy.

These observations are of very exceptional phenomena and they should not be interpreted as a confirmation of the Bank of Finland's position as a modern central bank. During the entire nineteenth century, the Bank of Finland acted more as a commercial bank than as an institution with responsibility to carry out discretionary monetary management. Its role as a government-supported commercial bank[16] was accentuated in 1859 when the bank was allowed to hold deposits from the public.

The role of the Bank of Finland as a central bank emerged very slowly during the late nineteenth century. The public deposit holdings with the Bank of Finland ceased in 1875 and the rediscounting of the bills of other commercial banks started gradually as early as the 1870s. But the use of the discount window only became more extensive during the 1890s.[17] The rediscount rate seems to have been the same as the minimum discount rate applied by the banks. The degree to which the banks used the discount window is not known before 1890, but the significance of this form of central bank borrowing increased during the 1890s. The smaller banks particularly used borrowing from the central bank as a regular channel to finance their activity.

The rediscounting of bills at the central bank increased rapidly and in 1907 the central bank placed quantitative limits on this kind of borrowing. The ceiling was expressed as a specific amount for certain banks. If the limit was exceeded, a higher discount rate was charged. Depending on the quality of bills, the maximum was a one per cent penalty charge.

To sum up, in the latter part of the nineteenth century certain measures were taken by the Bank of Finland which could be characterized as typical central bank policy measures (for example, rediscounting bills, 'active' interest rate policy and control of credit facilities). However, this picture is ambiguous and Rossi claims that the Board of Governors of the Bank of Finland was unaware of the principles of interest rate policy as late as during the First World War (Rossi, 1951). As a result, the discount rate policy was seen as an instrument to compete with the commercial banks for customers rather than as a part of the interest rate policy to maintain economic balance.

The aftermath of the First World War

After the outbreak of war, both Finland and Sweden were exposed to large economic shocks that pushed them off the gold standard. Both eventually returned to gold: Sweden in 1924, as the first country in Europe, and Finland in 1925. However, the routes taken by these two countries differed sharply. Sweden went back to gold at the pre-war parity after a rapid deflation. Finland returned to gold at the going rate. The macroeconomic consequences of these two strategies were quite different. Sweden suffered from deflation and the international post-war contraction, while Finland was more or less unaffected.[18]

In early 1921, the international depression seriously threatened the Finnish export industry and led to a deterioration of the trade balance.[19] The Finnish currency depreciated on the international currency market and the Bank of Finland decided not to support it in this situation. One reason, beside the low level of foreign reserves, was that the depreciation was one way of affecting the activity level in the economy. At this time, an increase in the discount rate was not seen as an effective measure against a weakened trade balance. To reduce the import surplus, the Supervisory Board recommended rationing credits for import purposes.

The Finnish currency was heavily depreciated at the end of 1921, the foreign deficit was eliminated in 1922 and money market conditions were eased. However, this favourable movement in market conditions (combined with an abandonment of the inflation economy) did not result in a lower interest rate level. In 1923/24, increased central bank lending to the public was discussed as one means of reducing interest rates. The new Governor of the Bank of Finland, Risto Ryti, considered discount policy to be an unsatisfactory method of influencing the level of interest rates. In order to improve the influence of the central bank over interest rates, he proposed for instance that central bank credit should be made available to export industries.

The political pressure to lower the rate of interest remained massive and both the Bank of Finland and the commercial banks were held responsible for the high interest rates. In 1925, the Bank of Finland lowered the discount rate twice, yet the commercial rates did not follow the discount rate. In this situation, the commercial banks agreed on a common reduction of deposit and loan rates at the end of October 1925. Two months later, after an initiative from the central bank, the central organizations of savings banks and co-op banks recommended to their member banks not to apply higher deposit rates than 7.5 per cent (the highest deposit rates in commercial banks were set at 7.25 per cent). However, the member banks did not, in general, follow this recommendation.

The low interest rate policy during the inter-war period

The return to the gold standard in 1926 was seen as a fundamental step towards a more stable monetary system. The public associated the high interest rate levels of the early 1920s with the turbulence of economic life during those years. Thus, it was expected that a return to the pre-war gold system would also restore the pre-war interest rate level.

When the interest rate remained at a high level, the monetary authorities and the banking sector as a whole were seen as responsible for this. Political pressure on the authorities increased. In the contemporary debate, a main reason for the high level of interest rates was the stiff competition between the different banks, which led to upward pressure on the interest rates paid on deposits. At the initiative of the Bank of Finland in 1926, negotiations were started in order to reach an agreement between the banks that would ease the competition between these institutions. The negotiations, in June 1926, resulted in recommendations to local savings banks and co-op banks to lower their deposit rates and to reduce the spread between deposit rates and loans rates. However, in January 1927, about 60 per cent of savings banks still continued with 8 per cent deposit rates, and the small savings banks as well as co-op banks argued that they, as the 'savers' banks', had a responsibility to the public to pay deposit rates as high as possible.

The discount rate of the central bank was lowered three times during 1927, from 7.5 per cent in March 1927 to 6.0 per cent in November of the same year. To increase the pressure on commercial banks to lower their rates, the central bank raised its own lending to the public and announced that the conditions for central bank borrowing by the banks would be tightened. Nevertheless, while the discount rate fell by 1.5 percentage points, the level of interest rates fell by only about 0.5 percentage points.

At the end of 1927, the Finnish economy experienced a speculative boom. Following a sharp deterioration of the trade balance and an alarming decline in the central bank's currency reserves, the Bank of Finland was finally forced to raise the discount rate. This signalled the breakdown of the 'low interest rate policy' and opened the way for the banking institutions to raise their interest rates again.

By late 1930, it had become apparent that if the banking institutions could not reach an interest rate agreement that would cover all banks, legislation would have to be used to lower interest rates. Against such threats, a new 'voluntary' interest rate agreement came into force in July 1931. This established the highest interest rate that could be charged on deposits, with all banks being covered by the new agreement. Banks were classified into three categories and the agreement determined the highest interest rate for each category. An interest rate committee was established in order to set the actual interest rates and to see that the agreement was followed by all banks. From 1931, the banking sector in Finland thus was gradually transformed into a cartel. This development had consequences for interest rate policy as, in such an environment, it became easier to manage the market rate of interest by means of the central bank borrowing rate. The interest rate agreement was later completed in 1952, 1953 and 1955 in order to unify the interest rates on all kinds of time deposits. In 1963, all demand deposits were also regulated by such agreements between banks.

The discount rate of four per cent remained unchanged between 1934 and 1947, while even the market rate seems to have remained stable. During those 13 years, the largest commercial banks only changed their deposit rates on one occasion, in 1936/37.

1950–90: the prosperity and termination of regulated money

Two main arguments for regulation may be distinguished. The first one is that there was political pressure on the Bank of Finland to maintain low levels of interest. In the 1930s, this was done in order to ease the burden of the depression. Subsequently, in the 1950s and 1960s, it was carried out again to encourage economic growth. The second reason is associated with the global crash of the financial sector in the 1930s. Though Finland managed the worldwide financial crash relatively well, confidence in the operation of financial markets was shaken and hence the speculative character of the financial markets has been used as a motive for the regulation and control of the financial sector.

The Second World War inflicted serious damage on Finland. Almost 100 000 lives were lost, a large part of the capital stock was destroyed and 12 per cent of the territory was annexed by the Soviet Union. Meanwhile, war reparations to the Soviet Union and the need for resettlement were a heavy burden on the nation. Finland decided to finance the reconstruction of the economy by using domestic funds.[20] The role of the government sector became very pronounced. The government was not only responsible for fiscal policy, but also for the allocation of major investments. Furthermore, a large part of total savings was generated by the public surplus.

Thus, we may conclude that the regulation which was started in the 1920s and 1930s, as a result of political necessity, and continued in the 1940s, as a result of convenience, was well suited to the reconstruction of the country after the Second World War. However, in the 1950s, the regulatory system was not removed when the economic circumstances became more normal again. Instead, the regulatory system was completed during this decade and remained in force for more than two decades thereafter until the early 1980s. Deregulation was therefore delayed by almost 20 years compared to many other European countries and even some years compared to the other Nordic countries.

It is surprising to see how simple the system was. On the other hand, we must recognize the primitive nature of the financial system in

Finland at that time. The bond and equity markets were both unsophisticated and small. A major part of savings was carried out either in the form of banking deposits (private sector) or in the form of budget surplus (public sector). The lack of foreign banks and foreign financial investment of any kind made the system easy to regulate.

After the Second World War, the interest rate policy of the Bank of Finland was focused mainly on discount rate changes. Through these changes, the central bank announced its intentions regarding the level of interest rates, in other words they were signals to the market of 'desirable' changes in the behaviour of the other financial actors. Although this method of control of the market rate has worked rather well when the level of interest rates has been rising, the central bank has been forced to 'negotiate' with the other banks in order to secure downward movements of interest rates.

In 1947, the discount window system was introduced when the Bank of Finland set quotas on the rediscount credit of the other banks. At that time, the other banks' borrowing at the central bank was rather limited and direct central bank loans both to the public sector and to firms were still extensive. The post-war discount window system based on a differential interest rate schedule was completed in 1951, when the penal charge on borrowing in excess of the quota was introduced. Although, this system was modified several times during the 1950s and 1960s, the basic structure remained the same.

A significant change in central bank financing occurred for the first time in 1975, when the call money market was opened. The quotas declined in importance since fluctuations in bank liquidity were now evened out in the call money market. Central bank borrowing remained the major source of bank liquidity and, accordingly, the actions of the banks in the money market reflected their position *vis-à-vis* the central bank. A limit was placed on the average monthly amount by which any bank could exceed its net overall overdraft, that is central bank borrowing plus borrowing from other commercial banks. If a bank exceeded this limit, it would be punished in the form of 'progressively stricter scrutiny by the central bank'.

Although the importance of the call market increased during the late 1970s, it was not until 1983 that the most important regulations were relaxed. The system of granting quotas for central bank finance was abolished and the call money rate became the marginal cost of central bank borrowing. Even more important was the revision of the lending rate regulations. This revision was one step in the deregulation process and the banks were now allowed to transfer some of their funding costs in unregulated markets to their lending rates. Thus, the first steps toward market-oriented interest rates were taken.

The breakdown of the regulatory system first started after the rapid development of financial innovations in international markets during the 1970s. This revealed the allocative inefficiency of the existing regulatory system combined with the problems of controlling the capital flows in a more open international financial system. The regulatory system never actually collapsed but rather was blown away by the winds of change in international financial markets.

The exchange rate systems since 1900

The main macroeconomic target of the Finnish central bank policy has historically been a stable external value of the *markka*. This target has been formulated in terms of silver, gold, sterling, US-dollar or a basket of foreign currencies.

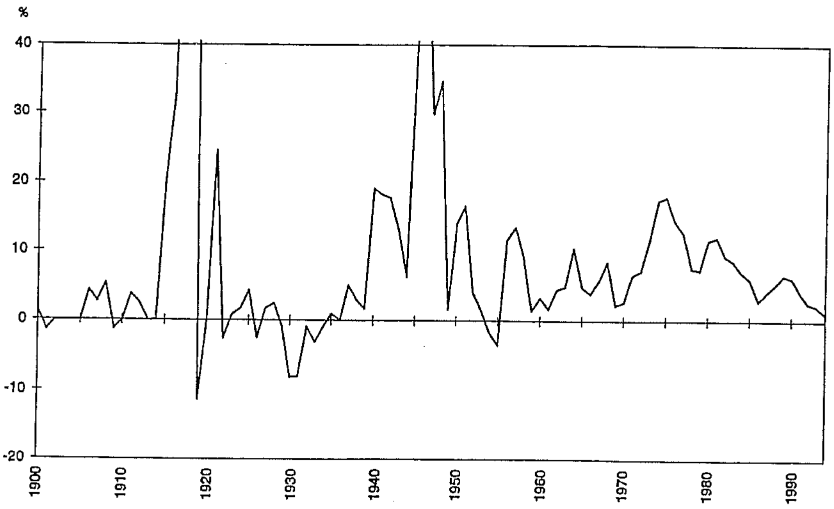
The suspensions of the gold standard in 1915 and 1931 were both due to external shocks; in the first case due to the outbreak of the First World War and, in the second, due to the world-wide recession which caused the UK, the main trading partner of Finland, to suspend the gold standard. Subsequently, the abandonment of a fixed exchange rate has as a rule been related to a continuous appreciation of the real exchange rate when the domestic inflation rate has exceeded the inflation rate of the main trading partners.

Finland made a major change in its exchange rate system in the autumn of 1992 when its currency was forced off the fixed exchange rate. Finland has had a floating exchange rate since then as well as an inflation target as a guide for its monetary policy. Here Finland was apparently inspired by Sweden's move towards inflation targeting.

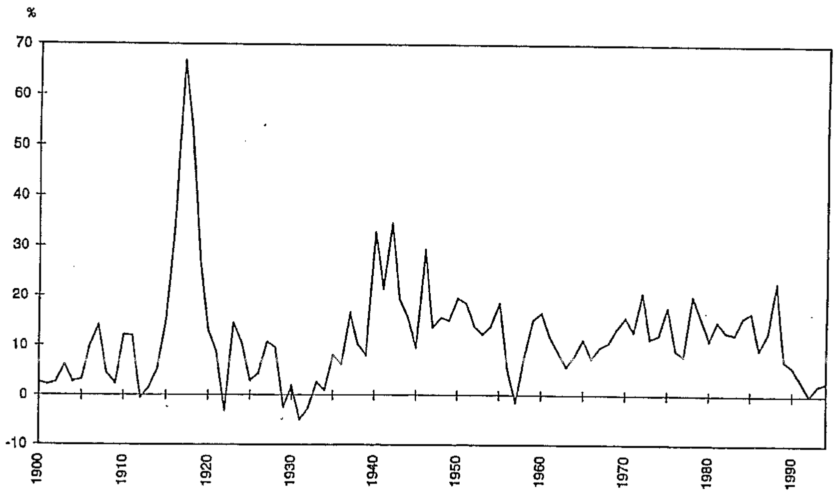
Figures 4.3 and 4.4 display the inflation rate and money stock growth in Finland between 1900 and 1994. The secular pattern of the former is similar to that of other Nordic countries. It can be divided into two distinct periods which are separated by the Second World War. The pre-Second World War period includes one inflation 'peak', namely the heavy inflation during the First World War. The significant difference relative to the pre-1939 period is that after the Second World War the price level has never declined. Rather, the latter has been a time of rapid monetary expansion in which the annual growth rate has fluctuated around 10 percentage points.

Foreign currency controls after the Second World War

Before the Second World War, the Finnish exchange markets had been completely free and open.[21] In 1939, currency controls were introduced with regard to foreign investment in Finnish equities. Subsequently, a



4.3 The rate of inflation in Finland, 1900–94, in per cent



4.4 Annual growth in the money stock of Finland, 1900–94, in per cent

more general currency regulation was introduced and all trade in foreign exchange was licensed. During 1940–41, the foreign exchange regulations were successively extended to cover all foreign payments.

Immediately after the war, currency regulation became a part of the reconstruction of the Finnish economy. The chronic trade balance was the main argument used to maintain the regulations. The 1948 and

1959 Exchange Control Acts rendered permanent the regulatory system introduced during the Second World War.[22]

The growth of foreign trade with western countries during the 1950s and 1960s together with a gradually more liberal trade regime were the major factors underlying the internationalization of the Finnish economy. In 1957, foreign trade was opened up and, after this reform, liberalized trade came to cover about 80 per cent of the value of imports. However, trade liberalization was not accompanied by a deregulation of capital movements. Only short-term capital flows related to financing foreign trade were allowed along with trade in securities on the Helsinki Stock Exchange.

Exchange rate legislation was reformed in 1959 and again in 1972. Changes in the regulatory system were intended to facilitate foreign trade and the short-term credits associated with foreign trade. In the 1960s trade-related transactions became free. However, most capital transactions were still subject to the authorization of the Bank of Finland and the Finns were not allowed to make portfolio investments abroad.

The liberalization of capital movements in Finland occurred during the 1980s. As pointed out above, the observed increased degree of openness during the earlier periods is mainly an optical illusion since it is explained by the rapid expansion of foreign trade. However, the increase in foreign borrowing was a new feature of the 1970s; the foreign debt expanded rapidly and loans were now taken on the commercial Euromarket, instead of via loan negotiations with international organizations, as had previously been the case.

In 1980, the Bank of Finland left the foreign exchange markets and the forward rate was subsequently determined by market forces. Banks were able to use both foreign currency denominated deposits and credits to cover their forward positions. For the domestic banks, this reform was of a great importance. Foreign capital markets became a complement to central bank borrowing and the forward exchange rate reflected changes in money market conditions.

The Foreign Exchange Act of 1986 still maintained the Bank of Finland's exchange control power, especially the control of capital movements and restrictions on portfolio investments. The Bank was granted wider-ranging powers to regulate foreign exchange with the aim of avoiding volatility coming from abroad. There was thus a policy which can be described as a step-by-step dismantling of the controls, although particularly in the case of the liberalization of portfolio investments this has been subject to extensive caution.

During the 1990s the dismantling of exchange control continued. The usefulness of exchange control as a policy instrument has decreased as a result of the global integration of the capital markets. However, the Bank of Finland's exchange control powers are still maintained by law. The main argument is the concern over disturbances caused by speculation or other uncertainties related to the integrated markets. Thus, attitudes regarding foreign exchange controls have switched. During the 1950s and 1960s, exchange control was a fundamental part of the governmental programme aimed at encouraging economic growth based on domestic investment. Today the Finnish authorities leave capital allocation to market forces.

The process of financial deregulation in Finland displays great similarities with that of Sweden. In both countries financial deregulation was accompanied by a boom and bust period with significant macroeconomic consequences. At present, the two countries have followed almost exactly the same macroeconomic course over the past ten years.[23] Indeed, the great resemblance between the Swedish and Finnish economies has inspired some economists to suggest a monetary union between the two countries as an alternative to membership in the EMU (Jonung and Sjöholm, 1996).

Summary

This account has demonstrated striking similarities between central banking in Sweden and Finland. The central banks in the two countries emerged gradually over time. The functions defining a modern central bank, such as having a monopoly of the issue of notes, accepting the role of lender of last resort and conducting monetary policy were established in the late nineteenth century and early twentieth century, roughly at the same time in the two countries. Here the two central banks followed more or less the general European pattern of central banking. There was a considerable influence on the financial and monetary systems from the United Kingdom and from Germany.

The breakdown of the gold standard initiated by the outbreak of the First World War allowed for different monetary policy strategies in the two countries. Sweden chose to return to the gold standard in 1922 at the pre-war parity rate. Finland went back to gold a few years later at a devalued rate. The Bank of Sweden did not regulate interest rates in the inter-war period. The Bank of Finland, however, tried in the 1920s to control domestic interest rates, subject to strong political pressure.

Both countries pursued a policy of low interest rates in the post-Second World War period when the central banks achieved far-reaching controls over the activities of the banking system. The aim of this policy was to increase economic growth and subsidize sectors according to political priorities. The regulation of domestic financial markets rested ultimately on tight exchange controls.

The non-market-oriented control of capital markets represented a shift in the balance of power between the central bank and the political system. Monetary policy became an integral element of stabilization and growth policies during the Bretton Woods period. The decision by the governor of the Bank of Sweden to resign in protest in 1948 marks this shift in the balance of power in Sweden. For about forty years, from the end of the 1940s till the end of the 1980s, the *Riksbank* was clearly influenced by the Ministry of Finance.

This loss of independence occurred in parallel with the disappearance of freely functioning financial markets. The emergence of a more independent *Riksbank* took place during the process of financial deregulation. It seems safe to conclude that 'free' capital markets are a prerequisite for central bank independence. Financial openness has allowed both central banks to enjoy greater independence from the executive power as well as facilitating the process towards independence.

Financial deregulation took place in Sweden and Finland later than in other OECD countries. In the early 1990s this process was associated with severe financial crises threatening to wipe out large parts of the financial sector and consequently forcing government measures to prop up the solvency of the banking system. The crises are of an identical nature in the two countries, as in both cases the budget deficit exploded and unemployment rose to an unprecedented level where it still remains.

The two countries have a history of frequent devaluations in the past 20 years. Both were outside the ERM mechanism and were forced to leave a fixed rate in the early 1990s. The Swedish and Finnish central banks are now trying to establish credibility for their currencies by a policy of low inflation and so far seem to have succeeded. Both countries presently maintain inflation targets adopted after the floating of their currencies. Both have been preparing to join the EMU, a step which will ultimately imply the end of the Bank of Sweden and the Bank of Finland as central banks.

Notes

1. We gratefully acknowledge constructive comments from Krister Andersson, Forest Capie, Bengt Dennis, Klas Fregert, Carl-Göran Lemne and Jaime Reis.
2. There is a recent interest in the evolution of central banking. See for example Capie et al. (1994), Goodhart (1988) and Toniolo (1988).
3. This section builds upon Fregert and Jonung (1996).

4. Larsson and Lindgren (1993) examine the rise of the commercial banking system. Jonung (1986) describes the history of private bank notes.
5. See Jonung (1984) for an account of the policy of the *Riksbank* during the classical gold standard.
6. As a result of the unconstitutional step of the *Riksbank* to abandon the gold standard in 1914, an escape clause was written into the constitution in 1915 allowing the Bank to suspend gold convertibility in an emergency. See Fregert and Jonung (1996). The policy of the Riksbank in the 1930s is covered by Jonung (1979).
7. The abandonment of the gold standard in 1931 was regarded as a temporary step. Every year until 1974 Parliament took a decision to prolong the suspension of the gold standard in order to maintain the legal base of the paper standard.
8. The protocols from the monthly meetings between the *Riksbank* and the commercial banks for the period 1956–73 are analysed by Jonung (1993a).
9. See Jonung (1993b) for an account of the driving forces behind the deregulation process.
10. Monetary and fiscal policies during the boom and bust episode are described in Jonung and Stymne (1996).
11. This step was taken at the initiative of the *Riksbank* after the consent of the government.
12. The term of office for the governor of the *Riksbank* is now five years, while the political electoral cycle is four years.
13. This historical background is carefully described in various monographs on the history of the Bank of Finland, see e.g. Pipping (1961, 1969) and Schybergson (1914) regarding the history of central banking in the nineteenth century, but also Aaku (1957), Lefgren (1975), Korpisaari (1920) and Kuusterä (1989), who provide descriptions of early banking in Finland.
14. In fact, the Tsar became subordinate to a Swedish constitution in Finland. The autocrat of Russia could not enact new laws or change existing ones without the approval of the Finnish Diet. The Tsar had, however, the right to issue decrees in matters which were not ruled by these laws.
15. The economic conditions to implement this monetary reform were the worst one can imagine. Beginning in 1862, there was a change in the climate with unusually long and severe winters. In 1867/68, Finland suffered the last famine in Western Europe. Thus, the introduction of the silver-*markka* was criticized in the contemporary debate, since it restricted those opportunities the authorities had to reduce the heavy burden of crop failure. The question was whether silver should be used to back up the new currency or to import foreign grain. Silver was used to back up the currency.
16. See Goodhart (1988: 88). The author distinguishes between government-sponsored commercial banks, i.e. the early stage with note issuing government banks, and modern central banks. In the Finnish case, as in Sweden, this transition occured successively.
17. For details see, Korpisaari (1920: 221), Thesleff (1909: 68), and Schybergson (1914: 247).
18. See Haavisto and Jonung (1995) for a comparison of economic policies and economic developments in Finland and Sweden during the period 1914–39.

19. Currency regulations were abolished during the autumn of 1920 and foreign trade was deregulated in April 1921. See Rossi (1951: 142–3).
20. Finland decided to stay outside the Marshall Aid programme that was a decisive stimulus to recovery in most other Western European countries.
21. Finland was one of a few European countries with a free foreign exchange market for most of the 1930s. On the other hand, most of the foreign trade was in terms of bilateral trade and, thus, the corresponding payments were effected by means of clearing arrangements.
22. For a comprehensive, chronological list of exchange control measures in Finland, see Lehto-Sinisalo (1992).
23. For an account see Jonung, Stymne and Söderström (1996).

References

Aaku, Eero (1957), *Suomen Liikepankit 1862–1955*, unpublished.

Aaltonen, A. et al. (1994), *Monetary Policy in Finland*, Bank of Finland Series A:92, Helsinki.

Autio, Jaakko (1992), *Valuuttakurssit Suomessa 1864, Katsaus ja tilastosarjat*, Bank of Finland Discussion Papers, Helsinki.

Capie, F., et al. (1994), *The Future of Central Banking. The Tercentenary Symposium of the Bank of England*, Cambridge, Cambridge University Press.

Elonen, Heikki E. (1992), 'Suomen Pankin lyhyt historiikki', in Ikonen, Autio and Elonen (eds), *Suomen Pankki ja 1930–luvun lama*, Bank of Finland Series A:85, Helsinki.

Fregert, K. and Jonung, L. (1996), 'Inflation and switches between specie and paper standards in Sweden 1668–1931. A public finance interpretation', *Scottish Journal of Political Economy.*

Frennberg, P. and Jonung, L. (1996), *Has the Riksbank Been Governed by Electoral Tactics?*, mimeo, Stockholm School of Economics.

Goodhart, C. (1988), *The Evolution of Central Banks*, Cambridge, MA, The MIT Press.

Haavisto, T. and Jonung, L. (1995), 'Off gold and back again: Finnish and Swedish monetary policies 1914–1925', in Feinstein, C. (ed.), *Banking, Currency, and Finance in Europe between the Wars*, Oxford, Clarendon Press.

Hörngren, L. and Lindberg, H. (1994), 'The struggle to turn the Swedish *krona* into a hard currency', in Åkerholm, J. and Giovannini, A., *Exchange Rate Policies in the Nordic Countries*, London, CEPR.

Jonung, L. (1979), 'Knut Wicksell's norm of price stabilization and Swedish monetary policy in the 1930s', *Journal of Monetary Economics*, (4).

Jonung, L. (1984), 'Swedish experience under the classical gold standard 1873–1914', in Bordo, M. and Schwartz, A. (eds), *The Classical Gold Standard in Retrospective*, University of Chicago Press/NBER.

Jonung, L. (1986), *Private Bank Notes in Sweden 1832–1902*, mimeo, Stockholm School of Economics.

Jonung, L. (1993a), 'Riksbanken i regleringsekonomin. Mötena mellan riksbanken och affärsbankerna 1956–1973' (The *Riksbank* in the regulated economy. Meetings between the *Riksbank* and the commercial banks 1956–1973), in Werin, L. (ed.), *Från räntereglering till inflationsnorm. Det finansiella systemet och Riksbankens politik 1945–1990*, Kristianstad, SNS förlag.

Jonung, L. (1993b), 'The rise and fall of credit controls: the case of Sweden 1939–89', in Bordo, M. and Capie, F. (eds), *Monetary Regimes in Transition*, Cambridge, Cambridge University Press.

Jonung, L. (1996), *The Decision-Makers' Views on Riksbank Policy. An Interview Study*, mimeo, Stockholm School of Economics.

Jonung, L. and Stymne, J. (1996), 'The great regime shift. Asset markets and economic activity in Sweden, 1985–93', in Capie, F. and Wood, G. (eds), *Credit Crunches and the Real Economy*, London, Macmillan.

Jonung, L., Stymne, J. and Söderström, H. (1996), 'Depression in the North – boom and bust in Sweden and Finland, 1985–93', *Finnish Economic Papers*, 9 (1).

Jonung. L. and Sjöholm, F. (1996), 'Bör Finland och Sverige bilda en valutaunion?'(Should Finland and Sweden form a currency union?), *Ekonomiska samfundets tidskrift*, no. 3–4.

Korpisaari, Paavo (1920), *Suomen Pankit.* Taloustieteellisiä tutkimuksia XXV, Porvoo.

Kuusterä, Antti (1989), *Valtion sijoitustoiminta pääomamarkkinoiden murroksessa 1859–1919*, Helsinki.

Larsson, M. and Lindgren, H. (1992), 'The political economy of banking: retail banking and corporate finance in Sweden, 1850–1939', in Cassis, Y. (ed.), *Finance and Financiers in European History*, Cambridge, Cambridge University Press.

Lefgren, J. (1975), *Banking in the Early Industrialization of Finland, 1860–1914*, PhD Dissertation, University of Utah.

Lehto-Sinisalo, Päivikki (1992), *The History of Exchange Control in Finland*, Working paper, Bank of Finland, 3/92, Helsinki.

Pipping, Hugo E. (1961), *Från pappersrubel till guldmark, Finlands Bank 1811–1877*, Helsinki.

Pipping, Hugo E. (1969), *I guldmyntfotens hägn, Finlands Bank 1878–1914*, Helsinki.

Rossi, Reino (1951), *Suomen pankin korkopolitiikka vuosina 1914–1938*, Institute of Economic Research, Series B:12, Bank of Finland, Helsinki.

Schybergson, Emil (1914), *Finland's Bank 1811–1911*, Helsinki.

Svensson, L. (1995), 'The Swedish experience of inflation targets', in Leiderman, L. and Svensson, L. (eds), *Inflation Targets*, London, CEPR.

Thesleff, Rolf (1909), *Den finska penningmarknaden 1879–1903*, Ekonomisk undersökning, Helsinki.

Toniolo, G. (ed.) (1988), *Central Banks' Independence in Historical Perspective*, de Gruyter, Berlin.