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FINLAND: Looking Outward for Future Economic Growth*

SUMMARY

Finnish government and business leaders often link their country's future economic growth prospects to the ability of Finnish firms to expand internationally both their operations and sales. Because of Finland's small domestic economy and its reliance on trade to maintain its relatively high standard of living, there is little disagreement in Finland on the need to maintain and improve international competitiveness and to expand trade. Helsinki approaches these objectives at the macroeconomic level by providing a stable economic environment and at the microeconomic level by encouraging greater development and application by industry of advanced technology. We expect Helsinki to become increasingly interested in expanding its Western economic ties in order to strengthen domestic firms, maintain export growth, and ensure long-run economic expansion. The Finns would favor most forms of trade, investment, or joint venture arrangements that would help improve domestic firms' technological capabilities and provide them with access to foreign markets. Helsinki will be careful, however, not to permit expanded economic ties with other Western countries--especially with the US--to be portrayed as in any way downplaying Finnish-Soviet relations. The Finns are particularly sensitive about anything that puts Finland in the position of jeopardizing its neutrality policy, which they rely on in order to deny the Soviets any reasons for interference in Finnish affairs.

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*This memorandum was prepared by [redacted] Office of European Analysis at the request of G.T. Underwood, Director of International Operations, Office of Productivity, Technology, and Innovation, Department of Commerce. Questions and comments can be directed to Chief, West Europe Division [redacted]

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GENERAL MACROECONOMIC CLIMATE

Finland has a healthy economy with no major long-term problems that are likely to force the government to alter its domestic economic policies. The economy has had positive growth every year since at least 1960, and has shifted from a predominantly agrarian base right after World War II to an industrial and service base currently. Helsinki recognizes that sustaining economic growth in future years will require increased trade with the West to acquire the high-tech components necessary for continued industrial innovation, as well as to provide markets for Finnish goods. The government perceives the importance of a stable domestic macroeconomic environment to this process. Consequently, economic policies are aimed at maintaining confidence in the Finnmark, controlling inflation, limiting the tax burden, deregulating financial markets, and reducing foreign-exchange restrictions. [redacted] 25X1

Short-Run Economic Outlook

While the long-term outlook for the Finnish economy remains good, the Social Democratic/Center/Swedish People's/Rural coalition government has adopted a mildly expansionary fiscal policy in the 1987 budget in the hopes of boosting sagging economic growth. Estimated growth for 1986 was about 1.5 percent, in contrast with a 2.9 percent rate for 1985, and the coalition seeks to improve its chances in the upcoming March parliamentary elections. The \$22-billion budget -- about 30 percent of GDP -- features income-tax cuts and an overall 8-percent nominal spending hike that Helsinki hopes will contribute at least 0.6 percentage points to GDP growth and may help push the rate back over 2 percent. The unemployment rate will probably exceed 7 percent in 1986 and 1987 following a 6.3 percent rate in 1985. [redacted] 25X1

*Finland's public-sector expenditures as a percentage of GDP is one of the lowest in West Europe. In 1984, total government outlays equaled 39.9 percent of GDP, compared with an average for OECD European countries of 50.6 percent and 49.3 percent for smaller European countries. Current receipts as a percentage of GDP have fluctuated between 35 and 40 percent for Finland over the last decade, while the OECD Europe average has been between 40 and 45 percent, with the average for smaller European countries slightly higher. [redacted] 25X1

*Compared with Sweden and Norway, Finland is relatively tolerant of unemployment. Polls indicate union members are most interested in job creation and job security, but recognize that unemployment is

The immediate factors behind the 1986 slowdown include several major strikes in the spring that helped push first-half industrial production 1.8 percent below the same period in 1985 and a sharp decline in Soviet trade. On the other hand, several positive factors helped temper slower growth. A decline in inflation from 5.9 percent to about 3.5 percent, a slight reduction in taxes, and pay settlements that provided real income increases combined to allow private consumption growth of over 3 percent, but this was not enough to offset flagging growth elsewhere. The growth in private consumption should continue in 1987, and, coupled with an expected improvement in exports to other Western countries, should help the economy remain steady. [REDACTED]

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MOVES TO IMPROVE LONG-RUN ECONOMIC OUTLOOK

Finnish government and business officials often link their country's future economic growth prospects to the ability of Finnish firms to expand internationally both their operations and sales. The Finns generally recognize that they must keep their economy open to trade and investment flows so that Finnish firms can obtain access to important Western technology. They also realize that maintaining an open economy will facilitate continued access to Western markets. Helsinki has been deregulating domestic financial markets and foreign exchange laws in the past few years, reflecting the government's view that increased exposure of the economy to foreign capital flows and business activity will provide opportunities for linkages with other Western economies. [REDACTED]

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An increasingly internationalized economy

Substantial changes have taken place in the structure of Finnish industry during the postwar years. Although the forest products industry is still of prime importance to Finland, diversification into other manufacturing sectors has reduced forest products to only 35 percent of total exports, down from 85 percent in 1960. Nonetheless, Finland's industrial firms -- even the larger multinational ones -- are hampered by their relatively late entry into international markets and by the small size of the domestic economy. Finnish firms typically rely on exports for most of their sales, and Helsinki recognizes that they would benefit substantially from expanded linkages with foreign firms. [REDACTED]

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often unavoidable because of the structural adjustments sometimes needed within industries to keep pace with structural changes in both domestic and foreign markets. [REDACTED]

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Finland increasingly linked its economy to the West during this time by joining the IMF (1948) and the GATT (1950). Finland also either joined or became associated with the OECD, the EC, and EFTA (European Free Trade Association) in the 1960s and early 1970s, and did likewise with EUREKA (1985) and the ESA (European Space Agency -- 1986). Helsinki actively supports international efforts to expand free trade in goods and services, and would be highly unlikely to jeopardize its economic relations with other countries by reversing its commercial policies -- particularly since trade is equivalent to almost 60 percent of GDP. Because of strong support for an open, private-enterprise economy, the Finnish government is unlikely to restrict repatriation of assets, profits, or technology by foreign firms. In addition, any change in laws that would alter protection of property rights for either Finnish citizens or foreign investors would, under the 1919 constitution, require a five-sixths majority for passage. The only support for such tampering would come from the Communists, who currently hold only 27 of 200 parliamentary seats and whose popularity is on the decline. [redacted]

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Competitiveness

Despite Finland's efforts to adjust to changing international economic conditions over the past few decades, Helsinki is concerned that the Finnish economy will face difficulties in the future because of sagging competitiveness. Wage costs are rising faster than in most competitor countries, and the spring 1986 settlements may boost 1987 labor costs by 7 percent. To combat an expected deterioration in competitiveness, the government will continue to fight inflation --which is about twice the rate of its main OECD trading partners at a 3.5-percent annual rate through October -- and promote increased competition in domestic markets. For example, the Finance Ministry has proposed expanding the access of foreign suppliers to bidding for public sector contracts as one way to tackle this problem. The government reasons this would not only expose domestic firms to more rigorous competition and improve the economy's efficiency, but could also provide goods at lower prices and help dampen inflation, which is about twice the rate of competitor countries at a 3.5 percent annual rate through October. This proposal also reflects Helsinki's general recognition that it must permit greater competition by foreign companies in the domestic market if Finnish firms are to keep up with the competition in foreign markets. [redacted]

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Changing financial markets

Helsinki has expressed its commitment to the openness of its economy by deregulating domestic capital markets and reducing foreign exchange restrictions during the past few years, actions which have improved the prospects for joint ventures and foreign direct investment in Finland. The trend towards relaxation of foreign exchange regulations also signifies that Finland's current policies of permitting full repatriation of profits and assets are not likely to be altered. This trend is likely to continue as Finland manifests its desire to obtain more technology from other countries through trade and investment arrangements. [redacted] 25X1

At the same time, the structure of the Finnish banking system is often cited as one of the main hindrances to the job-creating potential of smaller businesses. The seven commercial banks -- two of which dominate the Finnish financial scene -- have close connections with the larger Finnish firms, and new firms can have difficulty obtaining finance. Financial market competition is also limited because dissemination of information on interest rates and other credit costs is relatively unsophisticated, and Finnish banks do not publish reference rates similar to prime rates. The close relationship of companies with their banks also lessens competition because of firms' tendency to stick with one lender instead of shopping around for potentially better financing packages. [redacted] 25X1

The growing presence of foreign banks in Finland has helped to increase competition in financial markets, however, and the probable passage of a bill reducing the portion of another firm's equity a bank may hold from 20 percent to 10 percent will help promote greater competition for corporate customers by banks. Furthermore, reforms in bank laws that cause savers to favor bank deposits over equity purchases are planned, which will help to capitalize firms and force banks to compete more intensively for deposits. In the past, credit was usually rationed on non-market criteria, but the increased ability of Finnish firms to engage in "grey market" transactions that skirted these restrictions forced the central bank to acknowledge the need to begin deregulating. [redacted] 25X1

Increased capital flows

The deregulation of foreign exchange controls that has also occurred in recent years reflects the government's desire that Finnish capital markets adapt to the increasing globalization of financial markets. Deregulation by Helsinki of firms' capital

transactions and financing activities in the early 1980s facilitated a surge in overseas investment, leading to a quadrupling in the markkaa value of Finnish foreign direct investment and a 30-percent increase in the number of Finnish firms operating overseas between 1981 and 1984. Foreign purchases of Finnish firms have not been as extensive, primarily because of the limited opportunities in Finland's small domestic market, restrictions that prohibit investment in mining, forestry, and insurance, and other, less-strict limits on investment in several smaller industries. In addition, the 20-percent ceiling on foreign ownership of a firm's outstanding shares of voting stock will soon be raised to 40 percent, but voting power of foreign investors will be limited to one-half that of Finnish shareholders. The government had wanted to raise the limit to only 33 percent while granting full voting power, but compromised with parliamentarians who objected to full voting rights for foreigners. Finnish firms should, nonetheless, be able to get larger infusions of outside capital, and foreign investors will probably continue to prefer investing in rather than managing Finnish firms. Raising the ownership ceiling is consistent with OECD efforts to liberalize international capital flows, but the restrictions on voting probably are not. [redacted]

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Potential conflicts with monetary policy

Helsinki's efforts to internationalize the economy could come into conflict with its monetary policy objectives. The central bank has increasingly used interest rate instruments to control credit expansion and inflation, and has sought to maintain a fixed exchange rate to strengthen confidence in the currency. Maintaining a strong markkaa when domestic inflation exceeds that of its trading partners could, however, hurt Finnish competitiveness by preventing the necessary exchange rate relative depreciation. In addition, Helsinki's deregulation of credit markets and foreign exchange regulations has complicated the task of keeping the exchange rate within its desired range. For example, increased arbitrage activities that exploit interest rate differentials between domestic and foreign bonds has made foreign exchange reserves increasingly vulnerable to speculative pressures. There is a risk that the central bank could use repeated speculative attacks on the currency as a pretext for reversing the trend towards deregulation.* We do not believe, however, that Helsinki is

*In mid-August 1986, a sudden flight from the Finnmark occurred largely because of uncertainty about how Finland would adjust to the sharp decline in Soviet trade that lower oil prices had

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likely to do so in the foreseeable future, except in the extreme case where the damage to the domestic economy -- such as a rapid increase in inflation -- becomes so serious as to override the benefits to Finland of deregulation. [redacted]

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FINLAND'S PURSUIT OF TECHNOLOGY

In the early 1970s Finland significantly improved its efforts to encourage development of high technology when the Science Policy Council proposed a target of 10-percent real annual growth in total resources devoted to research and increasingly larger government expenditures to support these activities.* At that time, the government began to support the R & D activities of businesses by granting loans, tax credits, and subsidies for product development. In addition, the government-funded Technical Research Center of Finland (VTT) -- originally founded during World War II -- was reorganized and rapidly expanded. Today it employs 2,300 people and conducts self-initiated applied technical research for industries that do not have jointly-owned research institutes. Another source of R & D financing is the special Bank of Finland "Sitra" fund, which supports risk-bearing product development projects for innovative enterprises. Moreover, there are 25 small research institutes subordinate to the various government ministries. In 1980, the Council reaffirmed Finland's technology policy through the 1990s, and R & D spending has met its goals of 10-percent annual growth since then. [redacted]

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induced. The central bank quickly responded by pushing the call money rate -- essentially a discount rate -- from about 11 percent to 40 percent within a two-week period. This action prevented the exchange rate from deviating from an intervention range that is tied to an index of currencies. The financial markets quickly perceived that the central bank was committed to maintaining its stable exchange rate policy at great cost; the markets soon stabilized; and the authorities lowered the call money rate back to about 13 percent by the end of September. [redacted]

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*The Science Policy Council is a cabinet advisory body responsible for the overall planning, direction, and coordination of research in Finland. It includes the prime minister, the Ministers of Education, Finance, Agriculture and Forestry, and Trade and Industry, two other cabinet-selected ministers, the Chairmen of the Central Board of Research Councils and the Council for Higher Education, and five others chosen for their knowledge of Finnish science and technology issues. [redacted]

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The clearest indication of the changing perspective of Finnish society on technological development is the erosion of the long-standing multi-party consensus that Finnish agriculture merits heavy subsidization and protection. Finns increasingly believe they should shift more resources into industrial R & D instead. Long-term trends in the Finnish economy have produced a migration of population from rural to urban areas because declines in agricultural employment have given way to industrial employment growth. At the same time, the interests of the Conservatives and the largely urban Social Democrats are converging because supporters of both movements are increasingly likely to be urban, white-collar workers. Although Social Democrats fought Conservatives in the 1917 Civil War, the former's identification with "proletarian" interests has declined, while association of the Conservatives with "big business" has become weaker. Still, the left wing of the SDP has recently unsuccessfully opposed government proposals that are seen as supporting business at the expense of workers, but we do not expect such efforts will have much influence on the generally positive government and public attitudes towards private industry. [redacted]

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Promoting Technological and R & D Cooperation

Helsinki hopes that more joint venture opportunities with Western firms will afford Finnish business greater access to advanced technology. The small scale of most Finnish companies forces them to spend a higher percentage of their earnings on research and development than similar firms in larger countries. Helsinki would also like to raise the technology intensity of Finnish industry. Finland ranks only in the bottom third of OECD countries in the proportion of exports with high research and development efforts (i.e., technology-oriented industries) to general manufacturing. In addition, Finland is in the middle third of OECD countries in the proportion of manufacturing value added to total manufacturing R & D. [redacted]

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One possible hindrance to Finland's R & D efforts is the shortage of engineers. Finnish firms have attempted to address this by establishing engineering development operations and recruiting engineers for them outside Finland. For example, Nokia has established a mobile telephone development group at the Oxford Science Park in the UK, and a pulp and paper engineering group in the US. [redacted]

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According to the US Embassy, most US-Finnish R & D and science and technology cooperation occurs within the private sector through licensing arrangements and other production and research

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arrangements. The private sector finances and conducts about 58 percent of all research, the government finances about 40 percent, and nonprofit organizations and foreign sources provide the rest. The government finances only about 10 percent of all R & D done by business -- which is low compared with most other OECD countries -- and Helsinki would welcome greater joint-venture cooperation to provide needed R & D funds. In early 1986 Helsinki signaled its commitment to supporting the linkage between technological development and increased foreign activity in the Finnish economy when it ignored strong domestic opposition to the acquisition of 70 percent of Valmet's elevator division by a US firm and approved the merger because of the technology Valmet would have access to. [redacted]

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Helsinki also encourages Finnish participation in international R & D cooperative efforts. One example is the government's Technology Development Center (TEKES) -- established in 1983 to coordinate R & D efforts and boost overall spending on R & D from 1.4 percent of GDP in 1985 to 2 percent by 1990 -- which has helped several firms gain participation in EUREKA projects. Helsinki has also sought participation in Common Market cooperative programs and increased cooperation with other Nordic countries, which is where Finnish firms often have their greatest success. For example, the Nordic Council of Ministers established the Nordic Council for Research Policy after recognizing that opportunities for Nordic research cooperation are only modestly exploited. This strategy seeks to capitalize on the advantages Nordic firms have within that region. [redacted]

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ECONOMIC RELATIONS WITH THE USSR

Despite its close political and economic relationship with the USSR, Finland recognizes that it must further its Western economic ties in order to obtain advanced technology. Finland relied on its balanced-trade clearing account arrangement with the Soviets to maintain economic growth in the early 1980s at a time when other Western economies were in recession. The decline in Finnish-Soviet trade in recent years -- especially in 1986 -- has impressed in Finland the need to rely less on the short-run stimulus that arrangement provided, and to emphasize long-run industrial strength instead. The Finns see limited opportunities to gain technological capabilities from cooperation with the Soviets. They appear skeptical that the Gorbachev economic reforms will significantly improve the quality of Soviet goods and technology. Nonetheless, they probably hope that increased trading opportunities will emerge from these reforms, and they want to maintain and improve their economic relations with the Soviets. Despite its skepticism of the

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[redacted]

potential of Moscow's proposed joint venture program, Helsinki will encourage some Finnish companies to participate. The two countries recently reached agreement on two joint ventures involving Finnair and OY Sadolin, a Finnish subsidiary of a Danish paint manufacturer. We expect that, despite the extensive efforts Helsinki puts into maintaining its economic relationship with Moscow, the Finns will be increasingly interested in new initiatives with Western economies, especially the US, that will help Finland boost its competitiveness, maintain export growth, and ensure long-run economic expansion. [redacted]

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POTENTIAL CONSTRAINTS ON INCREASED ECONOMIC TIES TO US

Finland would welcome expanded economic ties to the US, but there are factors that could complicate such efforts. The nature of Fenno-Soviet relations could potentially dampen the Finns' enthusiasm for such ties at some point in the future. Consequently, the Finns will avoid giving Moscow the impression that widely expanded economic ties with the West in any way imply a downplaying of bilateral relations. Finland might blame the US for jeopardizing Finland's postwar security policy if closer economic cooperation led to sharp criticism by Moscow. [redacted]

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No amount of Finnish-US economic cooperation over the foreseeable future will affect Finnish attitudes so sharply as to convince them to significantly alter their security policy. Polls show that, despite their wariness of the Soviets, the Finns perceive the US as a greater threat to world peace than the USSR. Finland may, therefore, be susceptible to portraying the US as the aggressor in the north -- which now features the Soviet submarine fleet on one side counterveiled by the US Forward Maritime Strategy on the other -- in an effort to quell Soviet criticism of expanded US-Finnish economic cooperation. [redacted]

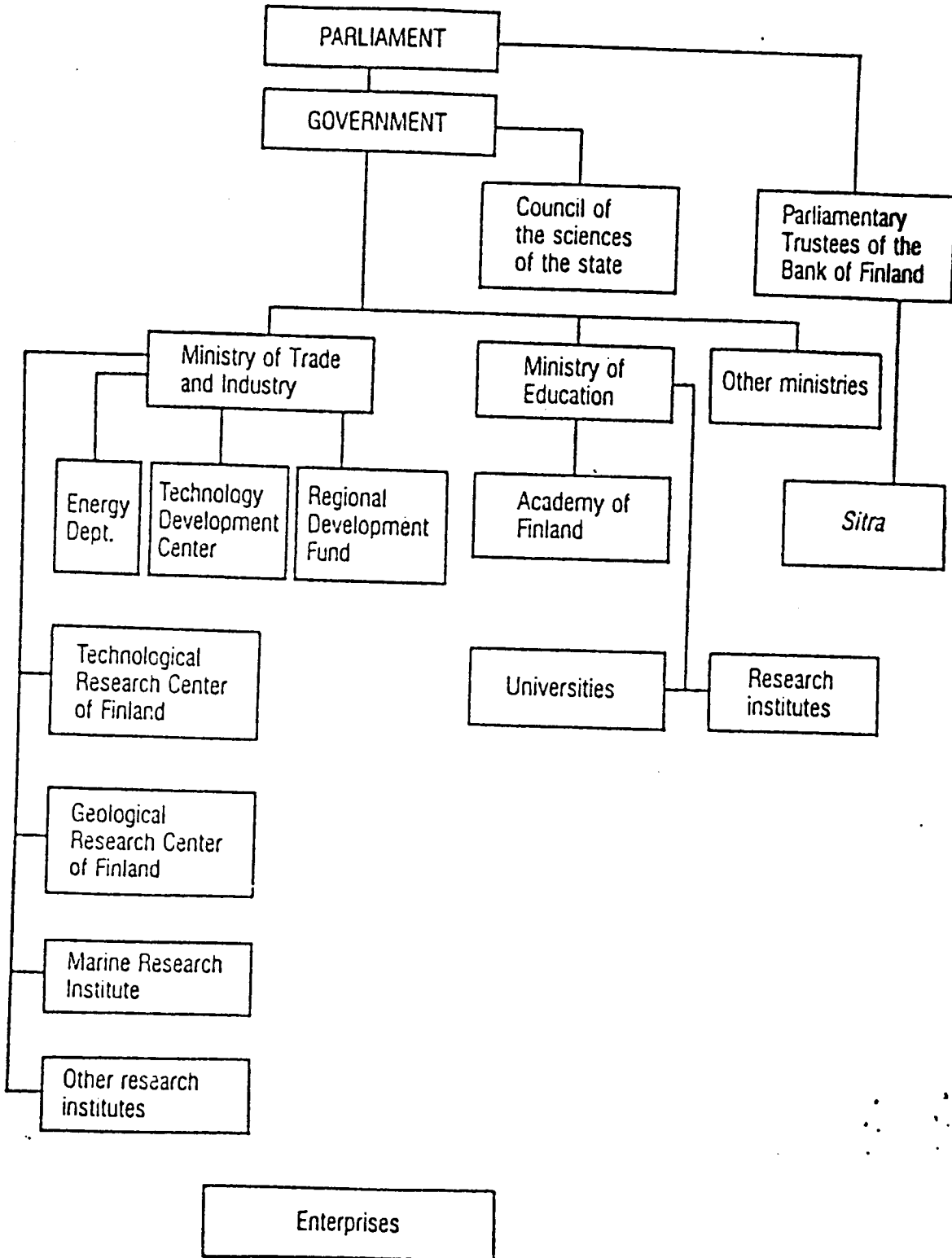
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The Finns' delicate balancing of their Eastern and Western interests complicates efforts to control technology transfers. Finnish government and business officials are sensitive to US concerns about reexporting US technology, and in general do not want to jeopardize their access to it. Although Helsinki does not ostensibly control exports of indigenously developed technology, it will continue to require licenses for exports to the USSR under the clearing account arrangement and will quietly seek to control reexport of third-country technology. Nonetheless, the Finns would probably perceive any restrictions they felt were unilaterally and arbitrarily imposed by the US after a joint-venture arrangement commenced as an attack on Finland's security interests and on its status as a Western democracy. [redacted]

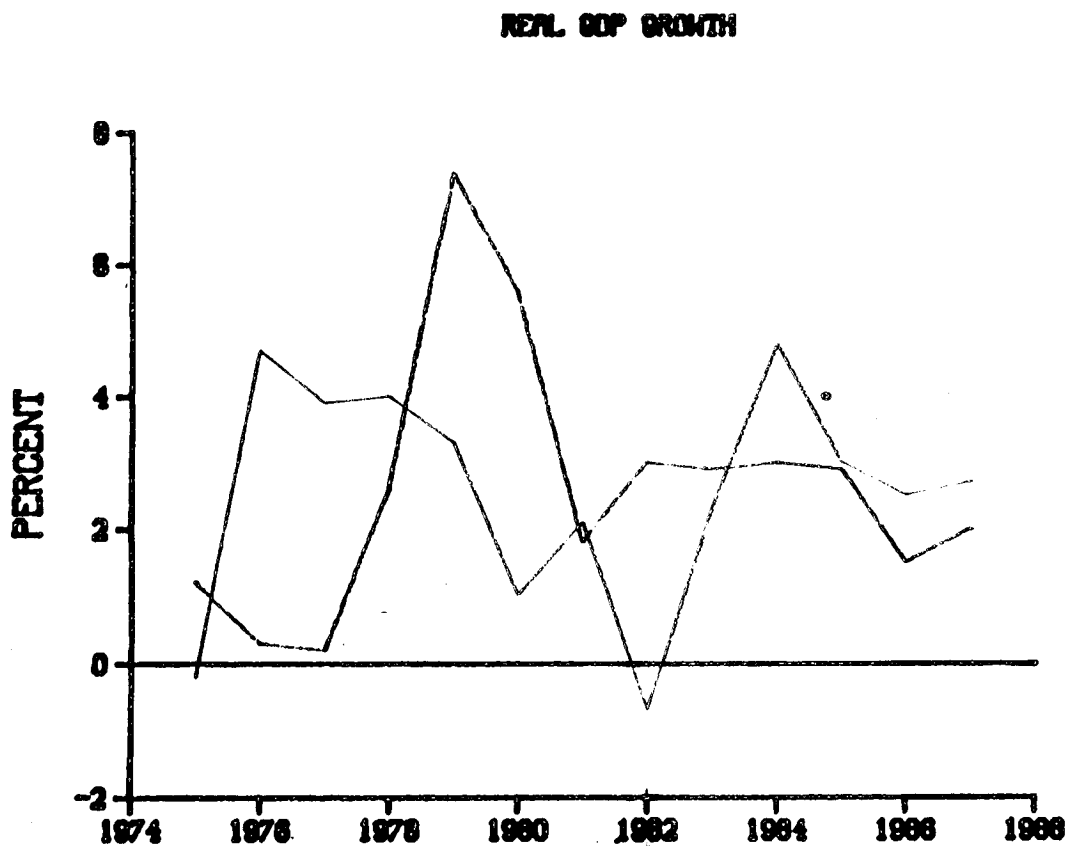
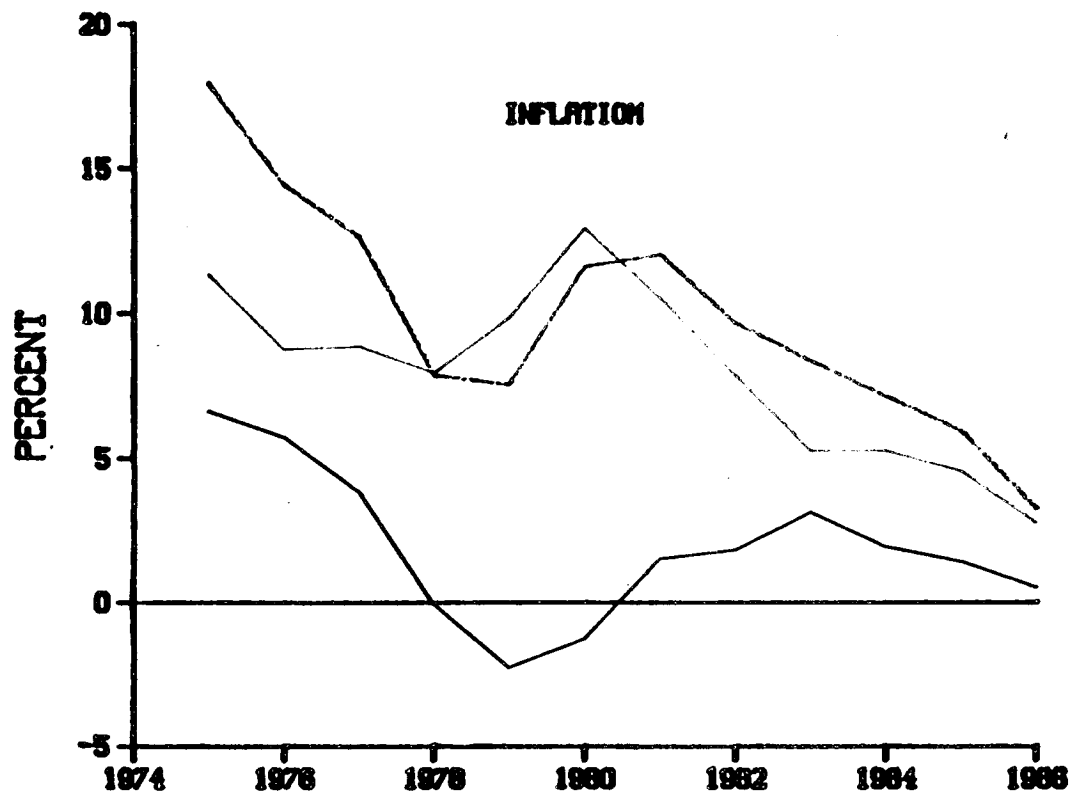
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FIGURE A:

FINLAND: SCIENCE AND TECHNOLOGY BUREAUCRACY



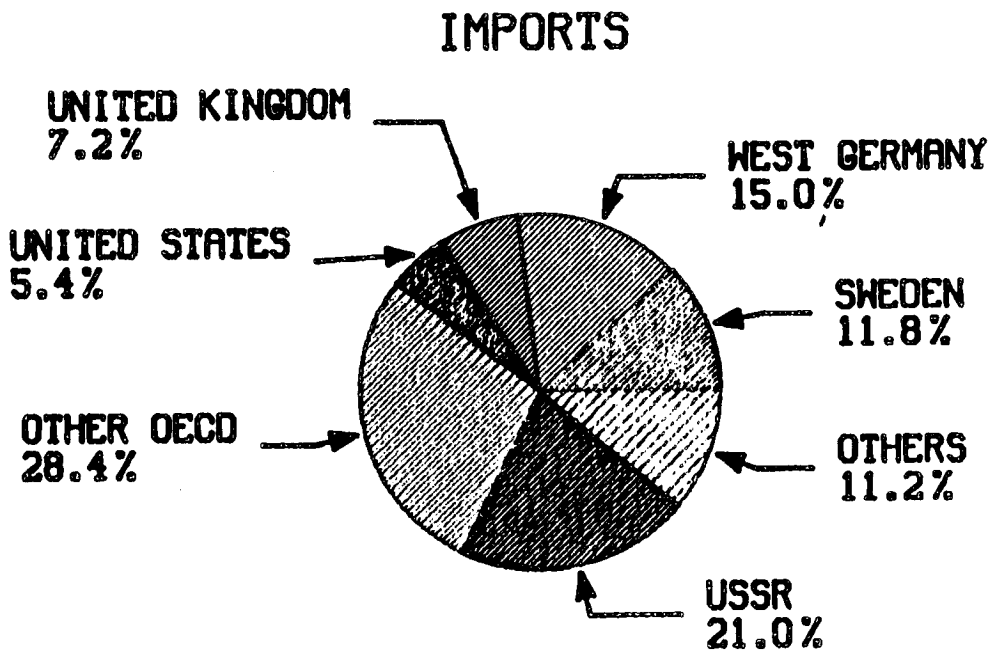
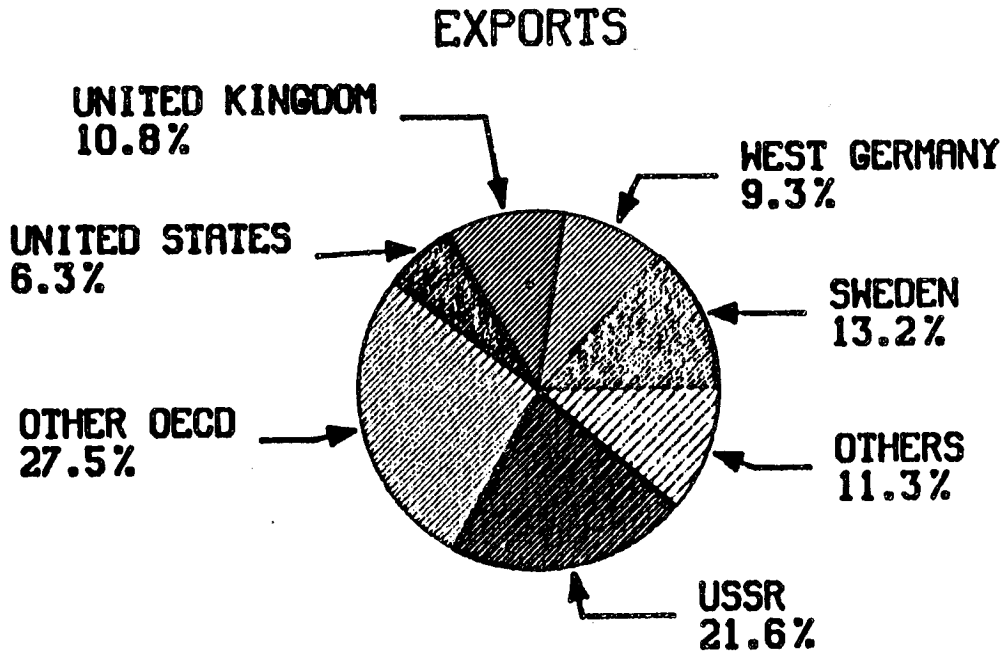
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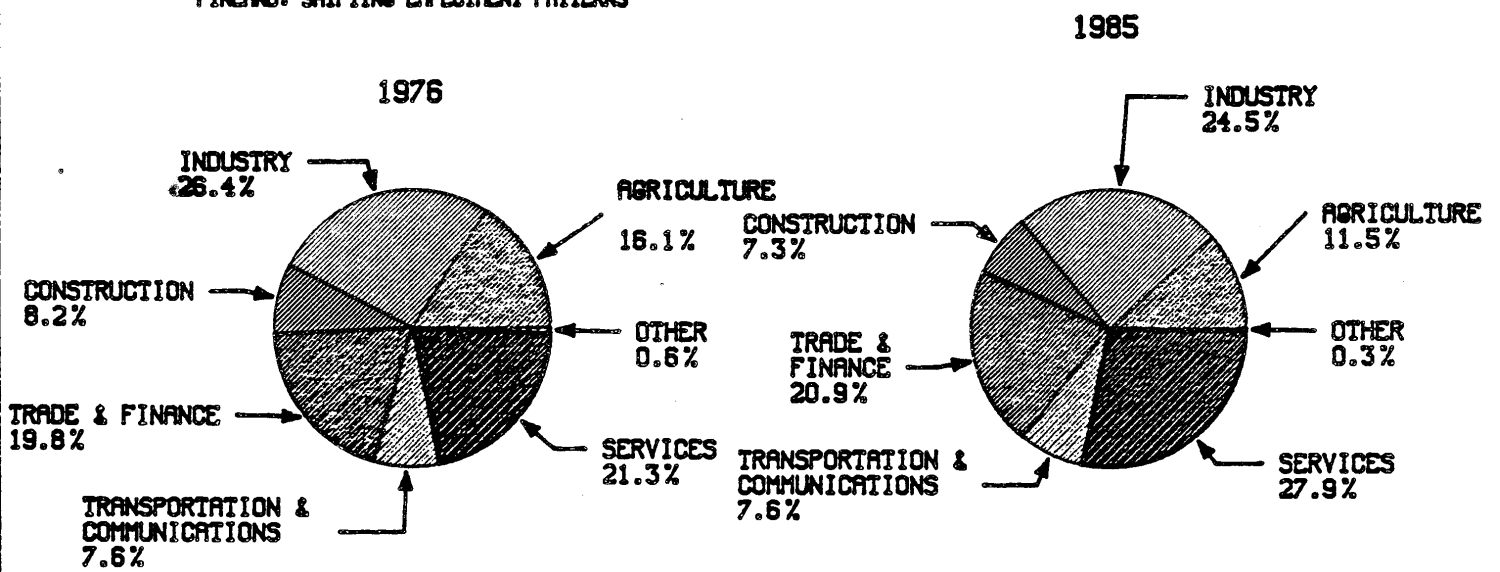
Legend
LINE 1
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1987=Forecast

FINLAND: DISTRIBUTION OF TRADE (1985 data)



FINLAND: SHIFTING EMPLOYMENT PATTERNS



[Redacted]

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