RIDING THE WAVE

Finland in the Changing Tides of Globalisation

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Preface

Recent years have witnessed a backlash to globalisation in many parts of the developed world. The belief that globalisation is harming rather than benefiting many citizens has gained currency and has been seen to be an important contributing factor in recent political upheavals, such as Brexit and the election of Donald Trump as US president.

While no developed country has been immune to the new scepticism about the benefits of global economic integration, policy makers in several small countries continue to believe in free trade and economic openness in general. Finland is one of those countries. The obvious question is why this "keep-calm-and-carry-on" attitude has prevailed in such countries. Is it perhaps because these countries had been miraculously saved from the adjustment pressures of globalisation, unlike other parts of the developed world?

This book is an attempt to shed light on this question by recounting the Finnish economic history during the different phases of globalisation. The answer that emerges is a resounding "no". Finland definitely has had its share of economic hardship and adjustment needs, many of which relate, in one way or another, to its international economic relations. The answer, rather, is that Finland has benefitted greatly from globalisation *in spite of* the serious turbulences that have been associated with it. In all critical junctures it has managed the adjustment processes, even if sometimes with unnecessary costs. We also hope to provide some explanations for the overall favourable cost-benefit outcome. Finally, we discuss the policy challenges and options going forward.

The conceptual framework for our discussion is provided by Richard Baldwin in his recent book "The Great Convergence: information technology and the new globalisation". The story we tell about Finland can be seen as an example of how a small country has navigated its way through the two eras of globalisation, called "first unbundling" and "second unbundling" by Baldwin. Baldwin's book is a fitting backdrop for our discussion of Finland, not only because of its contents but also because some key elements of Baldwin's analysis emerged in the report he wrote for a globalisation project for the Finnish Prime Minister's Office in 2006.

The book is joint effort by Jyrki Ali-Yrkkö, Markku Lehmus, Petri Rouvinen and myself. We are grateful for the help from several people at Etla, including, and especially, Mika Maliranta for productivity data and Kimmo Aaltonen for layout. Many thanks go also to Viv Davies for his excellent editing of the text.

Vesa Vihriälä

Riding the Wave: Finland in the Changing Tides of Globalisation

Summary: The book recounts Finnish economic history during the different phases of globalisation as defined and analysed by Richard Baldwin in "The Great Convergence: Information Technology and the New Globalisation". We demonstrate that Finland has benefited a great deal from its participation in the international division of labour and exchange, and that this is not due to exceptionally favourable endowments or a lack of disturbances and adversities. While errors in policy have not been avoided, the broad approach, i.e. the Finnish version of the so-called 'Nordic model', has been appropriate. It has embraced economic and political openness and sought to increase the economy's capacity to take advantage of emerging opportunities and to strengthen its resilience. The last ten years have again been difficult and revealed the vulnerability of a small specialised economy. However, after almost a decade of stagnation, the economy has recently shown strong signs of a rebound again. We conclude that the Nordic model is also the best starting point for Finland with regard to the new challenges of technological change and global competition. Nevertheless, policies need to be sharpened, including increasing the flexibility of the labour market and further improving competences and innovation capacity.

Keywords: globalisation; free trade; openness; convergence; Finland

Aallon mukana: Suomi globalisaation tyrskyissä

Tiivistelmä: Kirja kuvaa Suomen talouden kehitystä globalisaation eri vaiheissa Richard Baldwinin kirjassaan "The Great Convergence: Information technology and the New Globalisation" esittämässä kehikossa. Osoitamme, että Suomi on hyötynyt suuresti osallistumisestaan kansainväliseen työnjakoon ja vaihdantaan ja että tämä ei ole johtunut poikkeuksellisista luonnonvaroista tai häiriöiden tai vaikeuksien puutteesta. Vaikka Suomi ei olekaan välttänyt politiikkavirheitä, politiikan peruslinja, Suomen versio ns. Pohjoismaisesta mallista, on ollut hyvä. Se on suhtautunut myönteisesti taloudelliseen ja poliittiseen avoimuuteen ja pyrkinyt lisäämään talouden kykyä hyötyä uusista mahdollisuuksista sekä vahvistamaan sen sopeutumiskykyä. Viimeiset kymmenen vuotta ovat olleet jälleen vaikea vaihe ja osoittaneet pienen erikoistuneen talouden haavoittuvuuden. Lähes vuosikymmenen stagnaation jälkeen talous on kuitenkin viime aikoina osoittanut vahvoja merkkejä tointumisesta. Päädymme siihen, että Pohjoismainen malli on paras lähtökohta Suomelle myös uusien teknologisten ja globaalin kilpailun tuomien haasteiden edessä. Politiikkaa on kuitenkin terävöitettävä, ml. työmarkkinoiden joustavuuden lisäämiseksi ja osaamisen ja innovaatiokyvyn parantamiseksi.

Asiasanat: globalisaatio, vapaakauppa, avoimuus, lähentyminen, Suomi

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Introduction and overview

A basic tenet of economic theory is that trade is good for economic efficiency and welfare. Given the resource limitations of most economies, international economic integration can be particularly beneficial for small countries. In keeping with this observation small countries tend to be more open to the outside world, not only in terms of foreign trade of goods and services, but also with regard to capital flows and migration. However, as a result, small countries need to be more specialised. They also have less power to influence the political and economic conditions within which they operate. Such countries are therefore likely to be more vulnerable to external economic and political shocks.

Finland has been a keen member of the group of counties that has pursued higher living standards through foreign trade, access to foreign capital, knowledge and even migratory flows. This positive attitude towards economic integration has been apparent throughout Finland's 100 years of independence, as indeed it was during the preceding years of autonomy, when the industrial revolution began to radically change the country's economic landscape. Even during recent years, when anti-globalisation attitudes have spread across the developed world, Finland has remained in the group of countries that has resisted imposing protectionist policies.

The fact that Finland has risen from a very poor country in the European periphery a hundred years ago, to one of the rich countries globally – and, according to some assessments, even to the very top in terms of quality of life (e.g. 'OECD Better Life Index) – would suggest that globalisation has served Finland well. An obvious question, then, is whether this success has been due to favourable conditions – for example, that Finland has been supported by exceptional resource endowments and saved from external political and economic turbulences, to the extent that it has been able to reap the benefits from economic openness without significant disturbances or adjustment problems.

This book seeks to demonstrate that this explanation has certainly not been the case, neither in the past nor currently. In fact, Finland has experienced many external shocks that have derailed its economic development, including during the most recent period of globalisation. Our thesis is that openness has benefited Finland *despite* many shocks and a lack of exceptional endowments, such as oil or gas, or a particularly advantageous location, and that sensible, if not always perfect, policies supported by solid institutions have been central to this outcome. Further, we maintain that embracing openness and being proactive in adjustment is the best way to meet the challenges now, and in the future.

Openness has benefited Finland despite many shocks

Our approach is to draw from Finnish economic history and, in particular, the country's participation in the global division of labour during the different phases of globalisation, as defined and analysed by Richard Baldwin in "The Great Convergence: Information Technology and the New Globalisation". Our emphasis is on the last twenty-five years, though we also discuss the opening up of the economy and the key economic outcomes from the onset of the industrial period in the middle of the 19th century.

The 'periodisation' of globalisation

We begin in Chapter 2 by summarising Baldwin's arguments regarding the 'periodisation of globalisation', which he describes as: (i) the **"first unbundling"** (which is divided into three acts: Act 1 is the period from the beginning of industrialisation to World War I (WWI); Act II is the political backlash period from the start of WWI to the end of World War II (WWII); and Act III is the post-war period up to around 1990); (ii) the **"second unbundling"**, (which extended from around 1990 to the present); and finally, (iii) the prospect of a **"third unbundling"**, which is potentially waiting just around the corner.

A peripheral Grand Duchy gets lifted by the first unbundling

Chapter 3 covers the entire period of the first unbundling. At the beginning of the first globalisation phase, up to the beginning of WWI in 1914, Finland was still an autonomous part of the Russian empire. Given the autonomy of the Grand Duchy, Finland could, to a significant degree, pursue its own economic policies. This opportunity was used to modernise the economy, in a number of different ways, most prominent of which were: (i) the promotion of the adoption of new technologies (steam-powered sawmills being a prime example); (ii) the building of logistical infrastructure (railroads, man-made improvements of the waterways); (iii) the promotion of education; (iv) establishing a stable monetary system; and (v) developing the financial institutions.

Foreign trade was a key driver of economic development during industrialisation

The expansion of foreign trade was a key driver of economic development during this first phase of industrialisation, with the import of technology and the immigration of entrepreneurs being important facilitating factors. Finland made use of its vast forest resources to become a major exporter of timber, sawn wood and, towards the end of the period, paper. The forest industry was the engine that powered Finland's early development. Gross Domestic Product (GDP) *per capita* rose virtually at the same rate as in Western Europe in general, though slightly less than in Sweden and Germany. The economic development was much better than in Russia. Natural resources do not provide the explanation for this difference, as Russia obviously had much larger forest resources than Finland. The crucial difference was the political and economic institutions, which in Finland had been formed during its 700 years of being a part of Sweden. Nevertheless, Finland remained the 'poor relation' to most western countries, given its low starting level and the average *per capita* growth rate.

An independent Finland continues to prosper in the headwinds of protectionism

WWI was a defining episode in Finnish history, as it led to the independence of Finland. Simultaneously, it was a huge economic shock, with GDP declining by over 30% over a couple of years. In the immediate aftermath of the war, Finland's economy was restructured in many ways, including by a major process of land reform and the reorientation of trade, as the Russian market suddenly became closed. The economy recovered surprisingly well, however, being driven again by forest industry exports. The protectionism of the interwar period did not affect Finland's economic openness to any significant extent; essentially, the share of foreign trade in GDP did not decline. Finland continued to grow at roughly the same rate as its key western European peers.

WWII was again a major shock for Finland, even though it was saved from the devastation experienced in the Soviet Union, the Baltics, Poland and Germany. Over 2% of the country's population was lost in combat, 10% of the area of the country had to be ceded, more than 10% of the population resettled, and, for several years, about 5% of GDP had to be paid out in war reparations. The war effort and these losses impoverished the country, even though GDP did not take a major hit. As in so many other countries, foreign trade dropped to a very low level during the war.

The new openness facilitates a 'great catch-up'

Following the war, Finland was keen to exploit the opportunities created by the new US-led 'world order', by embracing free trade and economic integration more generally. Within this, however, the country was constrained by its delicate political situation, lying within the shadow of the now-very-powerful Soviet Union. For example, Finland was unable to benefit from the Marshall Plan. Nevertheless, Finland became a member of the key international institutional groupings, including the International Monetary Fund (IMF), the World Bank and the Organisation for Economic Cooperation and Development (OECD). It also participated fully in trade liberalisation within the General Agreement on Tariffs and Trade (GATT), and became part of the European Free Trade Association (EFTA). Simultaneously, it conducted bilateral trade with the Soviet Union, importing oil and raw materials, while exporting manufactured goods.

The key element of the growth strategy adopted after the war, and maintained until the 1980s, was the promotion of investment financed by domestic savings. Expanding the capacity of export industries was a priority. While the forest industry remained the backbone of the export sector, the metal industry also expanded significantly. Foreign trade, as a share of GDP increased consistently (as in other developed countries), reaching its pre-war level by the 1980s. The economy witnessed a steady structural change, wherein the share of primary production declined, while manufacturing, and later services, increased. During the 1980s, the expansion of foreign trade was increasingly accompanied by a deeper internationalisation through financial investments in both directions, facilitated by financial market liberalisation.

Expanding the capacity of the export industries was a priority

From the early 1960s, Finland began to follow the other Nordic countries in building a welfare state in order to protect its citizens against many kinds of risks (e.g. unemployment, incapacity to work due to sickness or old age, etc.) and to provide comprehensive health care, social care and education services. The expansion and qualitative improvements in the education system were prominent in this respect. The expansion of social safety nets and many of these services were motivated, apart from distributional objectives, by the belief that these expenditures would also increase economic growth through higher productivity and a better capacity to bear risks associated with economic activity.

The growth strategy proved to be highly successful. With an average annual growth rate of GDP *per capita* of 3.5% during the post-war period, Finland caught up significantly with the more advanced western economies, reaching 70% of the US GDP *per capita* level, lagging only a little behind Sweden, and matching West Germany. Yet consumption opportunities did not grow equally as well, as investment spending took an exceptionally high share of total demand and turned out to be relatively inefficient in terms of productivity impacts. Nevertheless, Finland was very successful in Baldwin's 'third act' of the 'first unbundling': the country was described as "The Japan of Europe" in the 1980s.

Macro shocks lead to a deep crisis, but with a silver lining

Chapter 4 describes how this glorious growth period ended in tears. Finland went through a financial crisis very similar to the crises experienced by Ireland and Spain post 2008. GDP declined by over 10%; 20% of jobs were lost, and the unemployment rate rose to close to 17%. It was fundamentally a macroeconomic crisis stemming from the excesses unleashed by badly managed financial liberalisation in the 1980s, and the collapse of the Soviet market following the dissolution of the Soviet Union. The crisis was aggravated, in a number of ways, by misguided policies.

The crisis induced reforms conducive to growth

While devastating for aggregate output and welfare, the crisis also led to important structural changes that were to help Finland recover and grow on a more sustainable basis. First, the crisis eliminated a considerable amount of low-productivity production that was directed towards the Soviet market and to satisfy domestic demand. Second, the crisis induced, or at least helped to implement, reforms conducive to growth. These involved an increased emphasis on innovation policy, including much more public spending on research and development (R&D), a further opening up of the economy through the membership of the European Union (EU), reforms to make taxation less distortionary, as well as stricter competition policy and better financial regulation. In addition, the crisis experience strengthened the consensus that public finances needed to be kept solid in good times, in order to have room for manoeuvre when crises emerged.

Finland becomes a model of success in the second unbundling

When Finland was in the midst of the economic crisis, the world was rapidly moving to a new phase in globalisation, i.e. the 'second unbundling' in Baldwin's terminology. Chapter 5 discusses how Finland made use of the new opportunities, not only to recover from the deep crisis but also to become a showcase for an innovation-driven economy capable of producing high and inclusive growth.

A key underpinning of Finland's economic performance from the mid-1990s to 2008 was the development of a knowledge economy. This comprised a highly-skilled labour force and strong public support for innovation activities. The reforms of the education system, which began in the 1960s and thereafter pursued consistently, had paid off, in the form of a substantial improvement in the competences of the labour force by the mid-1990s. The public R&D promotion that began in the 1980s was taken to a new level in the 1990s, through significant increases of resources and a better focus of policy to target a limited number of economic clusters, while avoiding picking winners among companies.

A key underpinning was the building of a knowledge economy

When the global economy emerged from the cyclical slump and simultaneously began to benefit from the new opportunities of a global division of labour, the Finnish business sector was in a good position to respond. The companies that had survived the 'steel bath' of the crisis were lean and competitive, and supported by a significant depreciation of the currency. There was also a considerable amount of well-educated labour available, and importantly, in the emerging information and communication technology (ICT) field, Finland had a company at the technological frontier with an ambitious new leadership – Nokia.

The result was very rapid export-led, and particularly ICT-production-led, growth, over more than a decade. GDP *per capita* grew by 3.5% annually, which was faster than in any EU country apart from Ireland, and considerably faster than the EU average of 1.8% and the US average of 1.9%. Finland again caught up with the richer countries, reaching 80% of the US

GDP *per capita* level, 95% of the Swedish level, and surpassing Germany by 3%. The growth was also quite inclusive. Income inequality increased somewhat in the 1990s but remained stable thereafter, at a comparatively low level internationally.

An important aspect of this growth period was a rapid internationalisation of the Finnish economy. Led by Nokia, many Finnish companies became truly international by setting up and acquiring foreign plants, and in terms of their financing and ownership models. At the same time, foreign direct investments in Finland increased considerably. A significant amount of economic activity in Finland became a part of global value chains (GVC). The ICT sector became the third pillar in the export industry, along with the forest industry and technology industry (excluding the ICT sector). This branch-level diversification notwithstanding, Finland's important export products were relatively few, and Nokia played an oversized role in the economy.

A series of shocks derails the economy again

This bout of rapid growth came to an abrupt end, just as did the boom at the end of the 1980s. As we discuss in Chapter 6, the trigger was again a macroeconomic shock, i.e. the global financial crisis in 2008. The crisis can be considered responsible for the bulk of the GDP decline of 8.3% in 2009. However, the original macroeconomic shock masked more structural ones, which were largely asymmetric concerning Finland more than other countries. The most important was the collapse of Nokia's position in the cell phone market, but also significant were the decline of paper demand, the global dearth of investment demand and, later, the collapse of Russian demand in 2014. These disturbances hit Finland very hard. The shining example of a successful innovation-based economy suddenly proved to be very vulnerable to shocks that were linked to the country's participation in the global division of labour.

Recovery has been painstakingly slow

Recovery from the shocks has been painstakingly slow. A recovery that has the signs of being sustainable began only in 2016, when GDP was still 4% below its peak prior to the crisis. The big puzzle is how an economy that has been ranked as one of the most competitive globally struggles for so many years to recover. While the jury is still out, our tentative explanation has three elements. First, the series of shocks were truly exceptional in size and largely permanent. Second, cost competitiveness was very slow to react to the asymmetric shocks in the absence of exchange rate adjustment – the labour market was not up to the requirements of a specialised part of a monetary union. Third, the real flexibility of the economy, in terms of developing completely new products and reallocating resources to their production, has been insufficient relative to the needs of the highly specialised economy. It might also be said that a part of the slow reaction stemmed from a complacency that was created on many levels – in companies, labour market organisations, and among policy makers – by the success of the economy following the 1990s crisis.

An interesting aspect of the most recent crisis is that neither income disparities nor poverty have increased. A key reason for this is that employment has kept up reasonably well, as the loss of production has mainly taken the form of a decline of productivity. But this outcome also reflects a Nordic welfare state in action, i.e. strong safety nets and strong automatic stabilisation built into the tax system, both facilitated by healthy public finances at the outset of the crisis. This protection against social pain has not come without cost, however. Public finances have weakened, to a degree that has led to consolidation measures already being implemented before full employment. It can also be argued that the relative painlessness of the shock has been a factor that has slowed down the necessary adjustment in the labour market.

The Finnish experience since the 1990s clearly illustrates the two sides of the most recent phase of globalisation with regard to a small economy. On the one hand, it provides a range of opportunities that can greatly benefit an innovative and developed economy. At the same time, the specialisation needed from a small economy to reap those benefits makes it vulnerable. If the shocks are big enough, even an economy with many strong fundamentals may struggle to adjust and recover.

With no alternative to openness, the Nordic model is a good basis to make the best of it

So, what does the future look like and what should a country like Finland do? The final chapter discusses these questions. While there appears to be a cessation in the deepening of globalisation, and protectionism has received some high-visibility supporters, we do not believe there will be any permanent reversal. The technological forces that drive globalisation are simply too powerful and hold too great a promise of benefits to be overturned. No country can escape this reality. The question now, particularly for the small countries, is how to navigate the waters of globalisation in order to reap the maximum benefits and minimise the inevitable adjustment costs.

In our view, the basic approach taken by Finland, along with the other Nordics, is sound. It is better to embrace globalisation than resist it, and to focus on making the country as strong as possible as a location for value creation, and to capture a reasonable share of that value for its own citizens. This will involve: supporting and developing Finnish people's competences; making the country attractive to foreign talents; promoting innovation; allowing market forces to determine the success or failure of companies; creating a flexible labour market in order to allow the labour force to be fully employed and reallocated (as is required for efficiency); providing insurance for people against the risks a dynamic economy is associated with; ensuring a stable macroeconomic environment; and further enhancing social capital built on trust, tolerance, security and efficient and un-corrupt authorities.

It is better to embrace globalisation than resist it

Nothing in these principles is new, and no-one can argue convincingly that even this recipe would make life easy in the face of constant technological change and fierce competition. However, in our view, it is the best option, and the focus should be on the best possible application of these tested principles.