16. DEVALUATION CYCLES IN SWEDEN AND FINLAND

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In both Finland and Sweden, the economic trend has been characterized by recurrent devaluations for a long period of time. Wages increasing too quickly, and cost crises with ensuing defensive or offensive devaluations have been well-known features of the economic-political picture on both sides of the Gulf of Bothnia. This has been such a regular pattern in both countries that it is possible to talk about a devaluation cycle. While the Finnish devaluation cycles started directly after WWII the pattern did not become regular in Sweden until the Bretton-Woods system broke up in the early 1970's. This is also the starting point for the period covered in this article.

However, the pattern of devaluation cycles came to an end due to the large, and in many ways similar, crises in both countries at the beginning of the 1990's. In connection with the crises, both countries changed exchange rate regimes; both went from an exchange rate target to a floating exchange rate with an inflation target.

In Finland, this regime was only a short-term intermediate solution before the country joined the ERM, and then the Euro. Sweden, on the other hand, has maintained the regime with a floating exchange rate and an inflation target for more than ten years. If there is a yes in the referendum in the fall (September 2003), Sweden will go the same way as Finland and adopt the Euro.

An important question for both countries is whether the forces creating the devaluation cycle under the previous regime are still active or whether the new regimes, possibly combined with a reform of the economies in the wake of the major crisis, mean that the requirements for continuous devaluations constitute a bygone stage for both countries.

If the answer to the question is no, that is if the underlying forces for devaluations still exist, there will be considerable problems in both regimes. Starting with the Swedish regime, the floating exchange rate can, in principle,

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currently satisfy a need for recurrent devaluations. In a very short perspective, the currency can depreciate, without violating the inflation target. However, relatively soon, recurrent depreciations will contribute to increasing the domestic rate of inflation. In order to defend the inflation target, the Riksbank will have to increase the interest rate so that inflation is kept down. In this scenario, the price for keeping down the inflation might be economic stagnation and growing unemployment. If, on the other hand, the Riksbank were to choose to accommodate the inflationary pressure and temporary or permanently abandoning the inflation target, it would risk losing its credibility. The price for this might also be very high, in the form of long periods with a considerable interest gap towards other countries until the confidence has been regained.

For a country that is part of the Euro area, the pressure to devaluate can naturally not be dealt with by new depreciations. In this regime, we might thus get too high a cost level, which must be regulated by a downward-adjustment of the relative wages. This might be a time-consuming process and must very possibly take place within the framework of economic stagnation and growing unemployment.

The question of whether the forces creating the recurrent devaluations in Finland and Sweden have now disappeared is thus of great importance for both countries. It is not, in any evident way, easier to deal with a recurrent pressure to devaluate within the framework of a floating exchange rate policy with a fixed inflation target than within the framework of a common European currency.

While few would deny the importance of this question, many might say that, in practice, it has already been answered by the actual trend. After the crisis in the early nineties, both Finland and Sweden have had a period of macroeconomic stability, which clearly differs from the turbulence in the period of devaluations, when there was a whole succession of macroeconomic crises.

Both countries have had considerable success in creating macroeconomic stability. However, it is also the case that this is largely due to the considerable depreciations in the wake of the crisis in the 1990's. In this context, Figure 16.1 is worth considering. Using a simple trend analysis as the starting point, it does not seem possible to claim that there has been a considerable break in the effective exchange rate trend for these two countries. After a strong downward deviation from the trend at the beginning of the 1990's, the countries are now once more approaching the trend. In this simple analytical

framework, the first signs of whether we are dealing with an actual break in the trend will only emerge in the next few years.

In this article, we will analyze this issue by a closer study of the Swedish and Finnish devaluation cycles. We shall discuss what have been the main driving forces of the cycles. Moreover, we will study the economic and political dynamics in the devaluation cycles. This will provide us with a background and an analytical framework for answering the initial question. We will return to this question at the end of the article.

There is a vast literature on devaluation cycles. Most of the research has been done with reference to one or several Latin American countries. Marion (1997) is one example of this. An early article on the devaluation cycle, which refers to the Finnish experiences after WWII is Korkman (1975). A description of the Swedish devaluation cycle is found in Jakobsson (1997).

The article is organised in the following way. In the next section we give a stylized description of the devaluation cycle. In the third section we analyze the actual experience of devaluation cycles in Sweden and Finland. In both countries the actual performance fits relatively well into the pattern outlined in the stylized description. In the fourth section we discuss the question of which are the driving forces behind devaluation cycle. On a general level we find a close interconnection between the political sphere and the economic sphere. On the one hand the stance of economic policy is an important factor driving the devaluation cycle. On the other hand the dynamics of

Figure 16.1. Relative Unit Labor Costs in Finland and Sweden (1970-2001)
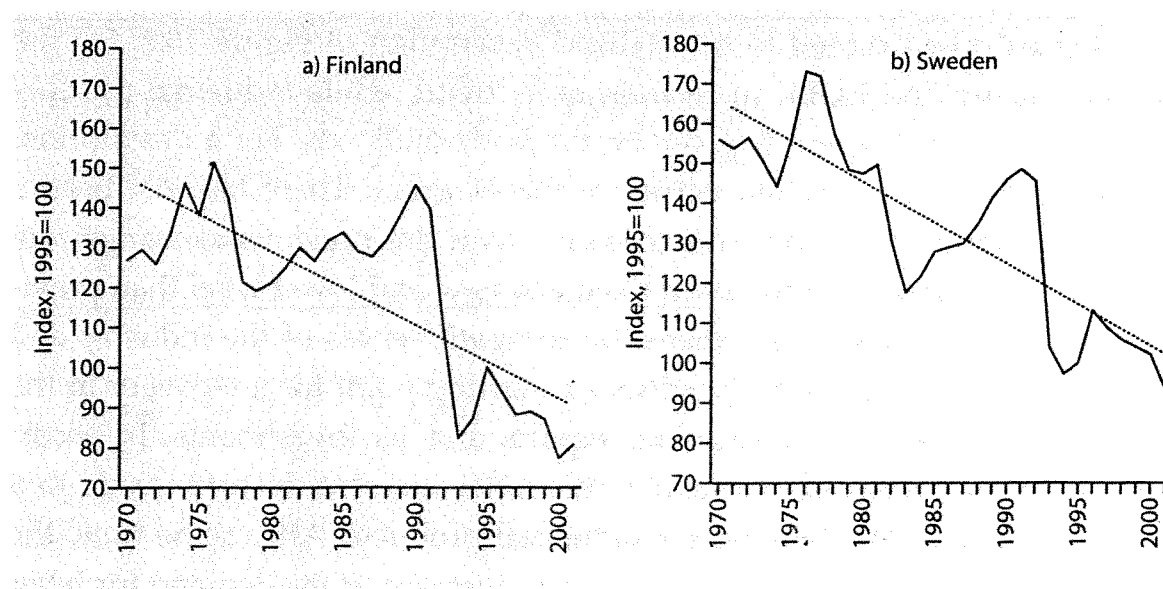
Note: The source is OECD Economic Outlook.

the devaluation cycle gives important repercussions to the political sector. This is discussed in section five. In the last two sections we analyze the question of what brought the devaluation cycle to an end. We also come back to the question whether the forces that created the devaluation cycle are now laid to rest.

A STYLIZED DESCRIPTION OF THE DEVALUATION CYCLE

It might be suitable to start the analysis by a stylized description of the basic pattern of the devaluation cycle. At a very general level, the devaluation cycle is a way of describing a recurrent pattern in the interplay between the exchange rate trend on the one hand and the real economy on the other. The variables on which we will concentrate here are the relative unit labor cost (RULC) and industrial production, respectively. In both cases, we study their deviation from a trend. RULC is a measure of Sweden's real exchange rate, which determines the cost competitiveness of the industry, which is the reason why it seems natural to choose industrial production as the real variable.

The cost of each unit produced is the ratio between wage costs and labor productivity. The relative wage cost per unit produced appears as the ratio between the ULC of the own country and a weighted average of the ULC of competing countries. With fixed exchange rates, the RULC is thus determined by the wage cost and the productivity in the country in relation to the corresponding variables in the other industrial countries. When the exchange rate for the currency of a country increases, so does its RULC, and the other way around when the exchange rate falls.

Let us now proceed to the stylized description in Figure 16.2. On the vertical axis we find RULC in relation to its trend, while industrial production in relation to its trend is given on the horizontal axis. For a description, we can start in the lower left corner of the diagram. There has just been a large depreciation here and in accordance with the previous exchange rate regime, the exchange rate has been fixed at a new and lower level than previously. The depreciation strengthens the competitiveness of the industry and increases its profits. Thus, it constitutes a starting point for a recovery in the industry. The industry increases its exports and its investments. In accordance with the accelerator principle, this latter increase, in turn, leads to a further increase in the demand for industrial products. After some time, the increase in industrial production leads to an increase in the demand for labor in the industry. In Sweden and Finland, this has usually led to wage inflation

taking off in the whole economy. Since the exchange rate is fixed, this leads to an increase in the relative wage cost in common currency. Increasing wages and growing employment also lead to an increase in domestic real income. Thus, there is also an increase in domestic demand in the economy. Another effect of this trend is that there is an increase in the tax base.

In the upper right-hand quadrant, we have, in summary, a situation where the economy starts to become overheated, with increasing wages, growing domestic demand and improved budget balances. At the same time, industry profits begin to fall, export volumes stagnate and industrial investments fall. Since the domestic part of the economy has now taken over the role as a driving force, the overheating can continue. The increase in private consumption is high. At the same time, the improved budget situation will lead to an increase in public consumption. The overheating, which is now basically nurtured by the domestic part of the economy, will finally lead to a cost crisis in the industry. The trigger might be a downturn in the international business cycle, which reinforces the problems in the exporting industry.

Figure 16.2. A Stylized Description of the Devaluation Cycle
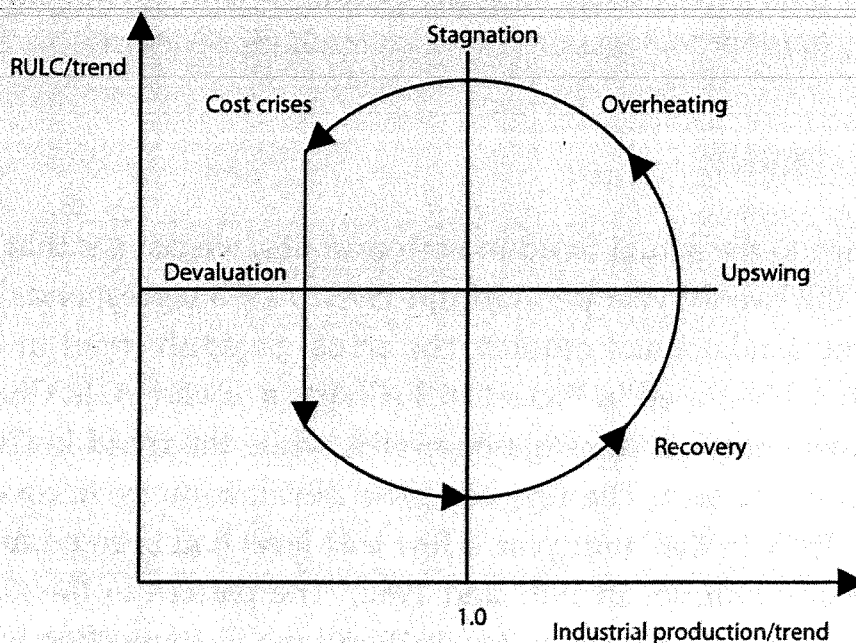
The decline in the industry, with falling profits, decreasing employment and falling investments, affects the rest of the economy in various ways. First of all, it contributes to creating an increasing pessimism in the entire economy, which is reinforced if the decline coincides with a weaker international trend. Furthermore, the decline in the industry contributes to a worsened economic situation in the public sector, which contributes to a stricter, or at least more cautious, fiscal policy.

Decreasing employment in the industry, weakened domestic finances and growing budget problems serve to augment the crisis. This is further reinforced by the fact that traders in the currency markets get the impression of *déjà-vu*. The distrust leads to speculations against the currency and increasing interest rates, which adds further to the economic decline. Eventually a devaluation seems inevitable. Thus, in the terms of the figure, we have returned to the starting point.

In the two western quadrants, the budget situation of the public sector is strained by growing expenses due to a weaker labor market and falling incomes due to a weakened tax base. When we come to the south western quadrant, the loss in terms-of-trade after the depreciation becomes an additional factor, which further weakens the budget. In the south western quadrant, we can thus expect fiscal austerity packages with cuts in expenses and tax increases in order to deal with the growing budget deficit.

THE REAL TREND

When we turn to the actual trend in both counties, we can see that the Swedish trend in the twenty-year period from 1973 to 1993 corresponds best to the pattern of the fundamental outline. The actual Swedish trend in the period 1973 to 2000 is illustrated in Figure 16.3 (Charts a, b and c). In Charts a) and b), we see two complete devaluation cycles, while the trend in Chart c) follows a different pattern. The first complete devaluation cycle covers the period 1973 to 1983. In the latter year, a low cost level had been established due to the large devaluations in 1981 and 1982.[1] The pattern in this devaluation cycle is interrupted by a smaller devaluation loop in connection with the devaluation in 1977. It was too small to create conditions for a recovery in the industry and accordingly, wage increases were modest in 1978. The strong fiscal expansion in 1979 and 1980 did, however, once more start driving the wage inflation. This paved the way for the devaluations in 1981 and 1982, amounting to 10 and 16 per cent, respectively. Despite the experience from the previous devaluation, the government was very optimistic that the large

devaluations in 1981 and 1982 would lead to the structural change that constituted the explicit goal of the devaluations.

Instead, as appears from Chart b), 1983 constituted the starting point of a devaluation cycle, which almost perfectly corresponds to the pattern in the fundamental outline in Figure 16.2. It came to an end with the exchange rate crisis and the large depreciation in 1992.

Then, the conditions for the stabilization policy were radically changed. First of all, Sweden abandoned the policy with a fixed exchange rate. The new exchange rate regime was a floating currency with an *inflationary target*. Furthermore, the Swedish Riksbank was restructured, so that its board became independent of the government. A ceiling for government

Figure 16.3. Devaluation Cycles in Sweden
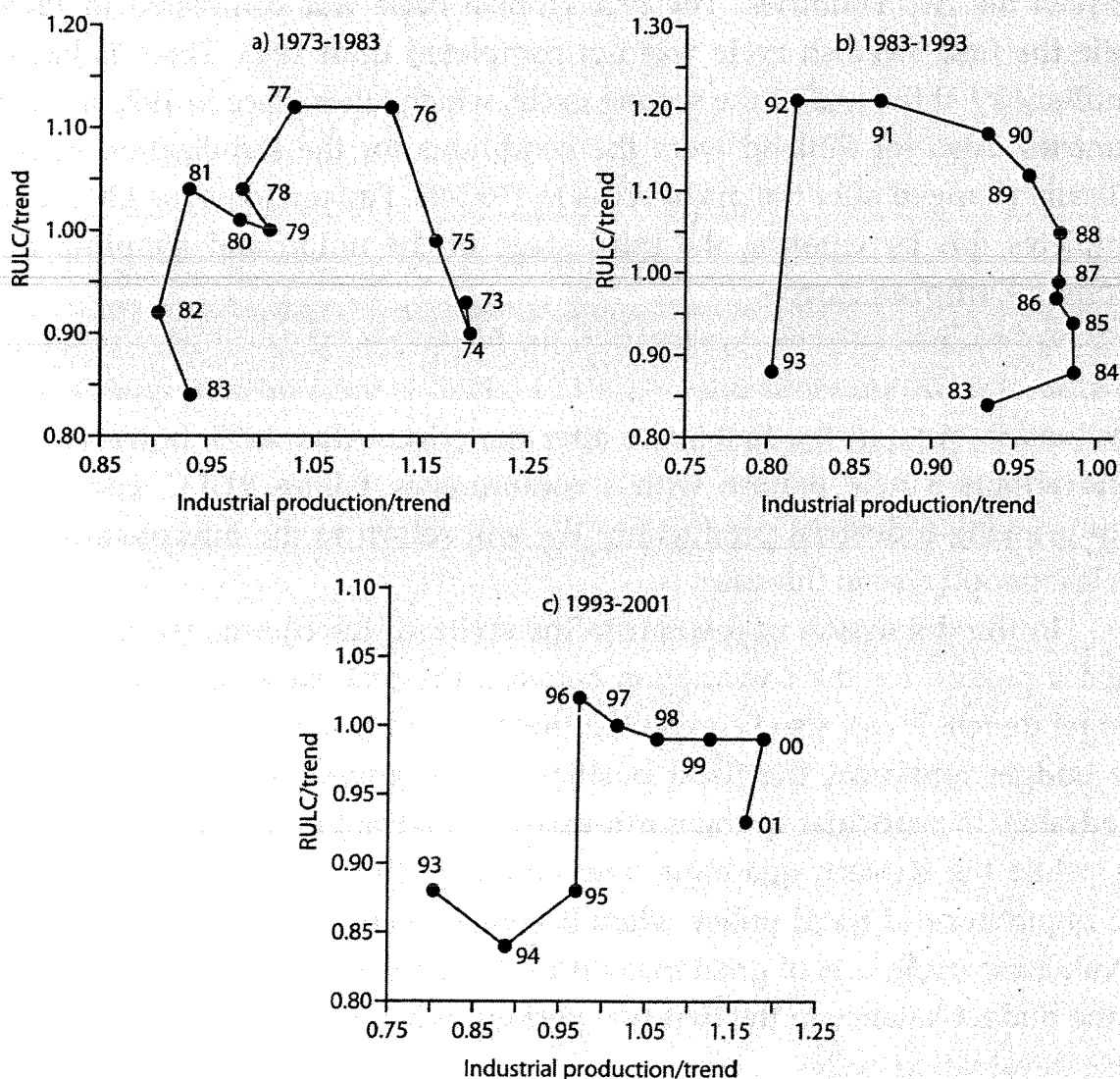
Note: The source is OECD Economic Outlook.

spending was introduced in the fiscal policy. Moreover, a long-term goal was introduced for the trend of the budget balance. With the entry into the EU in 1996, Sweden also became a member of the EMU; the independence of the Riksbank and the budget goal can be considered as direct consequences of this.

The observed pattern in the period after 1993 also very obviously deviates from the both previous time periods. Initially, we do find an attempt at a new devaluation cycle. After 1996, the trend adopts another pattern, however. We shall return to the question of whether this means that the old pattern has now entirely disappeared.

The real trend in Finland is illustrated in Figure 16.4 (Charts a, b and c). Also in this case, there are obvious cycles in the first two time periods, even if the deviations from the pattern in the stylized description are somewhat larger than for Sweden. The division into periods also differs somewhat between the two countries. The first Finnish cycle was completed in 1978, while the first Swedish cycle was not completed until 1983. There is larger simultaneity at the end of the second cycle, which takes place in 1993 in both countries. Also for Finland were the conditions for the stabilization policy radically changed after the major crisis in 1992-93. Finland joins the EMU and completes this by entering the third stage of the union and adopting the common European currency.

As can be expected, the trend in the last period thus differs considerably from the two previous ones. Also in Finland is there an attempt at a new devaluation cycle in the first years after the crisis. After 1995, however, the trend adopts a new pattern with a continuously falling RULC, combined with growing industrial production. We will return to the interpretation of the last period also in this case.

In the discussion in relation to the stylized description, we also indicated a pattern for the co-variation between the real exchange rate and the budget deficit. It can also be expected that the strong automatic stabilizer[2] in the budget reinforces the fiscal position of the government in the eastern quadrants, in particular in the north-eastern quadrant of the devaluation cycle, while the western quadrants are automatically weakened. Considering the importance of fiscal policy when it comes to creating conditions for the devaluation cycle, it is of great interest to study the real trend when it comes to the budget balance in the first two periods, when both countries had complete devaluation cycles.

The real trend for this variable in Sweden is shown in Figure 16.5 (Charts a and b) and for Finland in Figure 16.6 (Charts a and b). In the case of

Sweden, we can see that the pattern for both cycles shows the expected trend. Most likely, the correlation between the automatic stabilizer in the budget on the one hand and discretionary economic policy on the other hand has been a driving force in the devaluation cycle. When the government budget shows a growing surplus in the upturn, this contributes to increasing the general euphoria characterizing the latter part of the upturn in the devaluation cycle. The growing surplus is considered as a signal of there being scope to commit to new expenditures or, alternatively, tax cuts. Part of the explanation for the drastic deterioration in the budget balance that we see in the western quadrants might be that fiscal policy commitments made at the end of the upturn now have full impact.
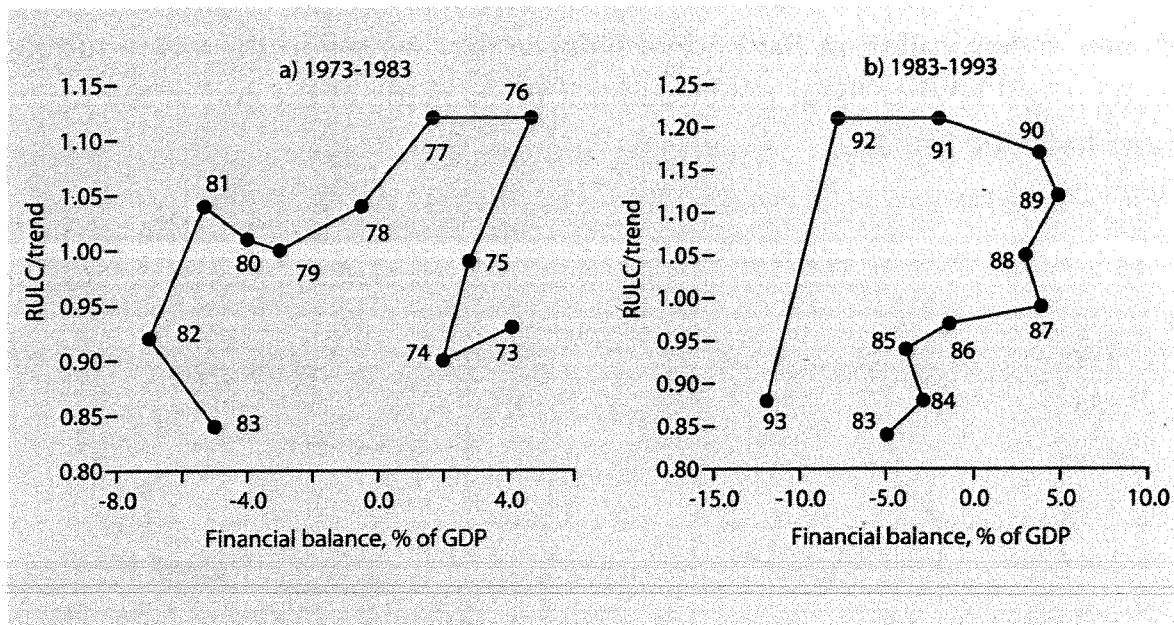
Figure 16.4. Devaluation Cycles in Finland
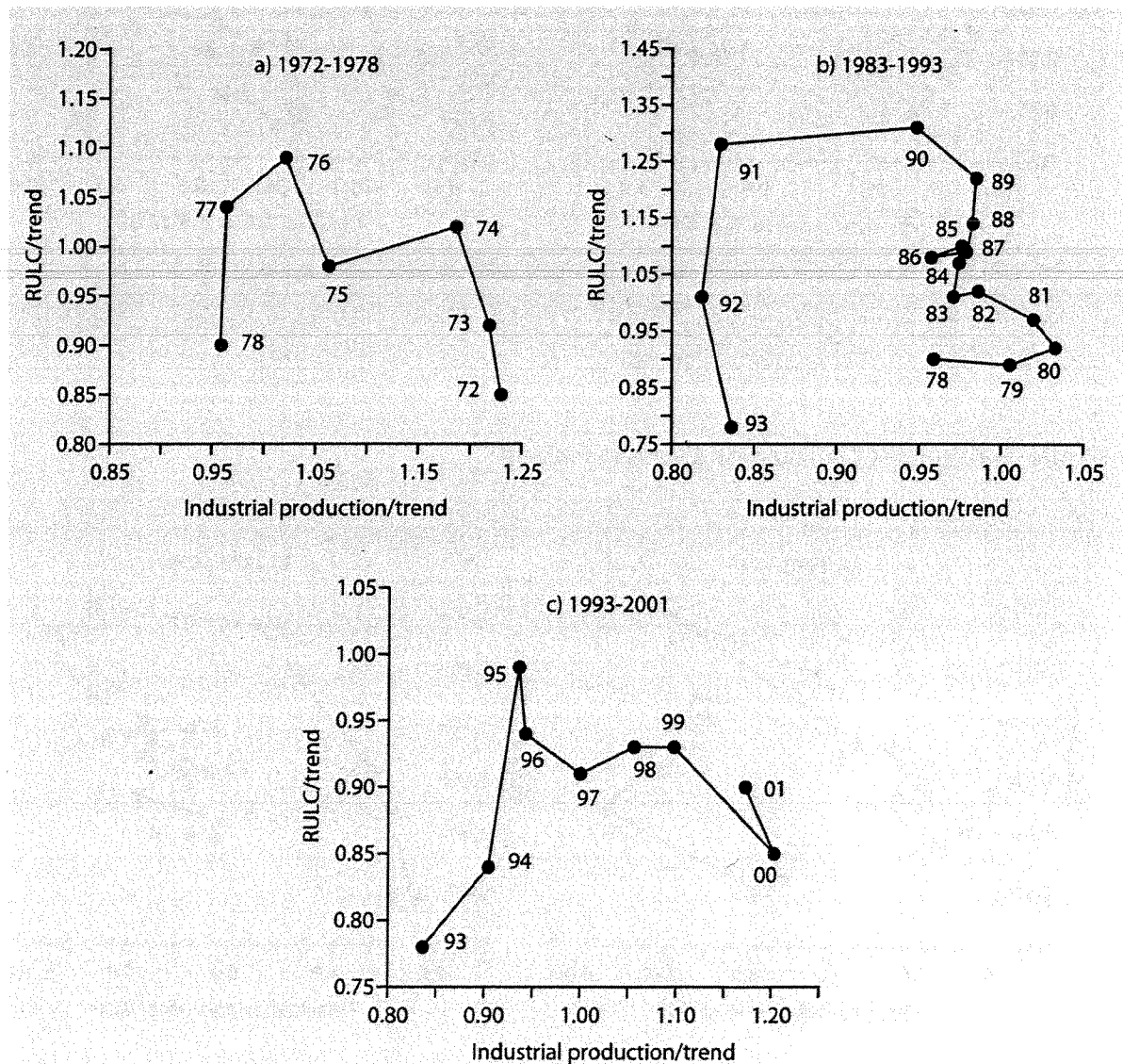
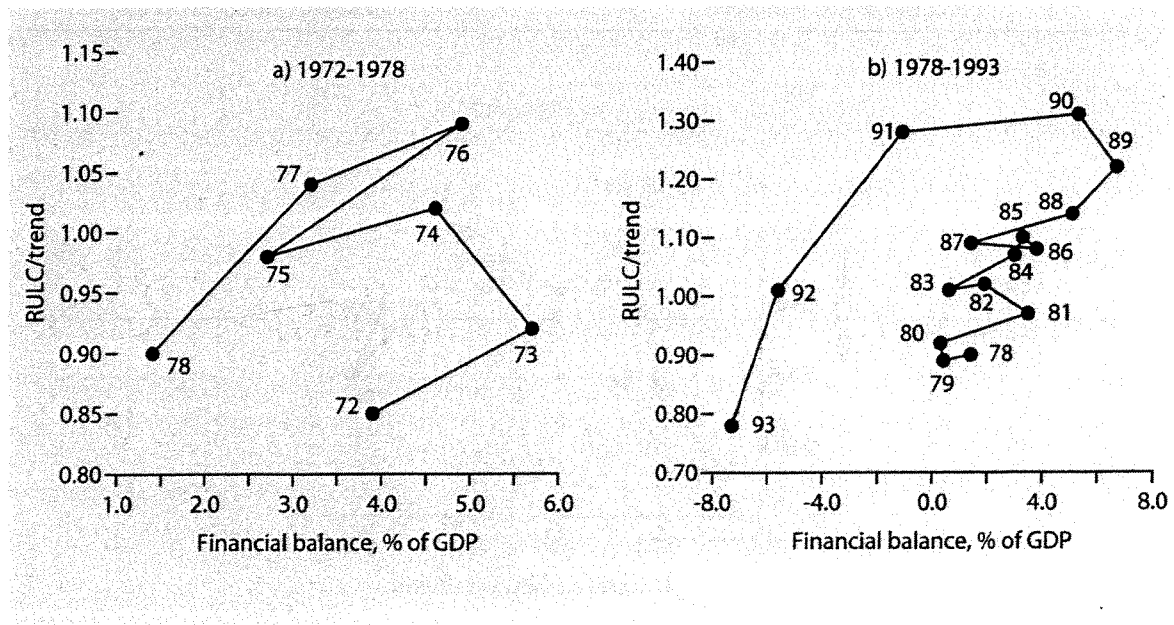Note: The source is OECD Economic Outlook.

The Finnish budget cycles also largely follow the pattern that has been outlined. In the first cycle, 1975 constitutes a deviation, which is difficult to explain. 1976, which constitutes the peak year in the north eastern quadrant, also gives the largest budget surplus. Then, in accordance with the stylized description, there is a drastic weakening when the cycle enters a downturn. If

Figure 16.5. Budget/Devaluation Cycles in Sweden

Note: The source is OECD Economic Outlook.

Figure 16.6. Budget/Devaluation Cycles in Finland

Note: The source is OECD Economic Outlook.

we go to the second time period, the budget cycle almost exactly corresponds to the stylized description.

THE DRIVING FORCES OF THE DEVALUATION CYCLE

We shall now deal with the question of what have been the driving forces in creating the devaluation cycles in both countries. There will be no general and complete statistical analysis of this question. Instead, we will point at two underlying factors that have been common for both countries and argue for their having been of decisive importance for the devaluation cycle.

Unemployment Has, for a Long Period of Time, Constantly Been Pressed Down below NAIRU

An almost obvious observation in connection with the devaluation cycle is that the wage costs in both Sweden and Finland have increased faster in the period 1970 to 1992 than in the other industrial countries. Depending somewhat on how the comparison group is defined, Swedish wages in local currency have increased about 35 per cent faster than in the average competitor country. The corresponding figure for Finland is even larger. Since productivity has not grown so much faster than in other industrial countries, it is obvious that this trend has contributed to decreasing the exchange rate.

The next question is then why wages have increased faster in these two countries than in the other industrial countries. An obvious reason might seem to be that wage formation has been inefficient. This "obvious reason" does, however, conflict with a considerable amount of research in this area. In the 1980's, several researchers claimed that wage formation worked better in Sweden than in the other industrial countries. In a number of studies, it appeared that Sweden was one of the countries in the OECD area where wage formation worked best, in the sense of the Swedish labor market showing considerable flexibility in real wages.[3] In an OECD study[4] belonging to this literature, both Sweden and Finland come out very favourably in an international comparison. As we have seen earlier in this article, the adjustment in real wages however was not achieved by low wage increases but by the devaluations being even larger than the wage increases. It is not obvious to all critics that such a trend should be interpreted as a country having a well-functioning wage formation.

Most likely, deficient wage formation should not be given too large a part of the blame for the trend creating the devaluation cycle. Instead, it is probably the case that due to the economic policy, wage formation was subject to more pressure than it could handle. One way of seeing this is to compare the unemployment figures in both countries with the estimates that have been made for NAIRU in the respective country. In Sweden, we find estimates for NAIRU in the interval of 3 to 3.5 per cent in the period before 1992[5]. For 1993 Forslund (1995) reports values between 4 and 6 percent. In Finland, the values of NAIRU have also increased over time albeit on a somewhat higher level than in Sweden. According to the estimates of Alho (2002), NAIRU took values around 4 percent in the period 1970-1983. Then the values increased until they reached 8 percent in the early 1990's. After that NAIRU has remained at that level.

If we compare the unemployment figures in these countries to these estimates, we find for Sweden that in each single year in this period, unemployment has been below the estimated value for NAIRU. In Finland unemployment has been below or just at NAIRU during the whole period. This is a sign that a too expansionary economic policy in the two countries has been of crucial importance for creating the devaluation cycle.

The question is thus how both countries could stick to a policy that was so obviously in conflict with such central goals for economic policy as low inflation and a fixed exchange rate. Considering Sweden, the fact that the government was assuming the entire responsibility for maintaining full employment is certainly an important explanation for the implemented policy. Full employment was moreover interpreted as a level of unemployment considerably below NAIRU. While the government was assuming responsibility for full employment, the labor market parties were, in practice, responsible for the inflation. It was also the case that the concept of NAIRU was not accepted at the political level. In the 1970's and 1980's, there was a strong belief that the strength of the Swedish labor movement could, in principle, make it possible to combine unemployment figures below NAIRU with non-inflationary wage increases. This view was manifested in a large number of political agreements, where the government, in a number of political concessions to the trade unions, tried to make these commit to low wage demands which would, in turn, lead to low overall wage increases. In Sweden, the so-called "Haga[6]-rounds" in the 1970's constituted a very clear example of this structure of the policy. On a permanently overheated labor market, this was a task that could not be handled by the trade unions. Accordingly, Sweden was heading towards a trend where too large wage increases became a threat to

full employment. This threat, in turn, was averted by a more expansionary fiscal policy and later on, new devaluations. This, in turn, meant that the ground was paved for continued wage inflation, which once more had to be accommodated by an expansionary fiscal policy and new devaluations, and so on. Finland's history of centralized tripartite wage agreements actually is longer than Sweden's[7]. Also here the ambition was to "beat the NAIRU" by policy agreements with the unions.

A Deteriorating Trend in the Real Exchange Rate

The devaluations in Sweden and Finland have not only served as adjustments of an inflationary wage trend. They have also constituted an adjustment to a decreasing relative wage-level in both countries. Already in Figure 16.1, we saw that there has been a deteriorating trend in the real exchange rate ever since the beginning of the 1970's. This indicates that there has been a *continuous decrease in the underlying competitiveness* in both Sweden and Finland. In order to deal with competition in the existing economic structure, there has been a need for a continuous downward adjustment of the relative wages. This trend has been most apparent in Sweden. The situation there is illustrated by the fact that the depreciation that became unavoidable in Sweden in 1992, started from a real exchange rate level about 25 per cent below the level at the time of the devaluation in 1977. If considering the entire time period, the real exchange rate in Sweden has fallen by 35 per cent. If we assume the wage increases in Sweden in this entire period to have been at the same level as in the other industrial countries and that this, in turn, has not affected the underlying competitiveness, Sweden would still have had to devaluate by around 30-40 per cent in that period in order to achieve the same cost competitiveness as today. The corresponding figures for Finland are of same order of magnitude.

When analyzing the reasons for this trend, it is important to note that it cannot be explained by the wage costs having been adjusted to a weak productivity trend. The real exchange rate trend emerges as the difference between the wage formation trend and the productivity trend. Thus, the productivity trend has already been weighted into the measure. Instead, the trend must be interpreted as the competition for the countries' products having becoming stiffer throughout, which has led to a downward adjustment of prices and thus, also costs. We shall return to possible explanatory factors for this in a later section.

THE POLITICAL DYNAMICS OF THE DEVALUATION CYCLES

We found in the previous section that one of the main driving forces behind the devaluation cycle was that unemployment was constantly pressed below NAIRU. The devaluation cycle was part of an economic policy that generally was too expansionary. On a very general level the devaluation cycles seem to have their origin in the political sphere. This is an indication that there is a connection between the devaluation cycles and the electoral cycles.

In the 1970's, William Nordhaus (1975) wrote a very influential article introducing a theory of *electoral cycles*. The main argument of this article was that in its attempt to gain voters in a coming election, the present government might be expected to carry out an excessive expansionary policy in order to increase its possibilities of being re-elected. The excesses before the election will then need to be corrected by a tightening after the election. This theory has been developed in a number of different articles and it has been empirically tested, with varying results.

An alternative theory developed by Douglas Hibbs (1977) among others, is that the nature of a policy before an election is determined by the political color of the government. A left-wing government can be expected to pursue an expansionary policy before the elections in order to show good unemployment figures. According to this theory, a conservative government can instead be expected to pursue a restrictive policy in order to show low inflation figures. This theory has also constituted the starting point of several empirical studies.

The theories have generated studies both on Swedish and Finnish data. A recent study on Finland is Nyberg (2000). On Sweden, studies have been made by Hibbs & Madsen (1981) and Jonung (1985). A general result of the studies is that elections are important for the timing of stabilization policy.

One can however not conclude that devaluation cycles simply are another incarnation of electoral cycles. There are important differences between the electoral cycles and the devaluation cycles we are analyzing in Finland and Sweden. There is e.g. an obvious difference in periodicity. The electorate cycle spans the election period, which both in Sweden and Finland is four years. In the theory of the electorate cycle the policy gets expansionary just before the election and more restrictive after the election. In the exposition of the devaluation cycle we have seen that the policy stance have been too expansionary, during periods of several years.

We have also found that an important feature of the of the devaluation cycle is, that the dynamics of the cycle tends to set the rhythm of the expan-

sions and restrictions, respectively. Figure 16.5 and Figure 16.6 give a clear indication of this feature.

The electoral cycle is, in theory shaped entirely by the political sphere. In analyzing the devaluation cycle we find important feedbacks from the economic sphere to the political sphere. We have just given one example of that. The dynamics of the devaluation cycle is also an important part of the environment in which the political parties are acting. We shall illustrate this with a reference to the Swedish case.

Since the beginning of the 1970's, there have been two periods with right of center governments in Sweden: 1976-1982 and 1991-1994. Both these government periods have thus started at the peak of the devaluation cycle and ended near its lowest level. The social democratic governments have thus administered the phases of recovery until about a year before the start of the cost crisis. For the fiscal policy, this means that the years that the right of center parties have been in power, have been years with large and growing budget deficits while the years when the Social Democrats have been in power, have been years with a good budget situation. In particular at the end of the recovery, the budget has shown a large surplus.

However, this cannot simply be interpreted as the Social Democrats generally carrying out a stricter fiscal policy than the right of center parties. Instead, as we have pointed out earlier, the policy has, in particular at the end of the recovery, been very expansionary, which has been hidden by the strong automatic feature in the budget.

The right of center budget trend has, on the other hand, been characterized by the decline, since the automatic feature has been working in the other direction. At the same time, the policy in the years when the right of center parties were in power must also be considered to be expansionary. In the first right of center government period, the policy from 1979 and onwards was very expansionary. Also in the second right of center government period was the decline met by very strong discretionary increases in public expenditure. It is, however, difficult to find any support for the theory that left of center governments would carry out a more expansionary policy than right of center governments on basis of the Swedish experiences. Using the period 1970 to 1992 as a starting point, it should also be difficult to argue that the opposite would hold. In the period of consolidation after 1992, a balancing of the budget, in combination with stricter regulations for fiscal policy, was implemented by a social democratic government.

THE END OF THE DEVALUATION CYCLES

In both Finland and Sweden, the devaluation cycles came to an end at the beginning of the 1990's. In both countries, a very deep macroeconomic crisis constituted the end of this era. GDP fell considerably in both countries and the unemployment figures rose very quickly to levels that would have been considered as entirely impossible, from a political point of view, only about a year before the crisis. The unemployment trend appears from Figure 16.7 (Charts a and b).

It is obvious that there were more profound reasons for the crisis than the cost crises that both economies had been subject to on a number of previous occasions. For both countries, there are a number of analyses on the reasons for the crisis[8]. In Finland, not least Pentti Vartia's work[9] has contributed to increasing the knowledge of the background to the deep crisis.

There is no space here to reproduce or even less to further develop these analyses. An interesting observation, however, is that in the 1980's, both countries underwent a considerable change in the direction of being liberal market economies. In particular, the capital markets were deregulated and interest rate regulation was abolished. This meant that the entire capital markets in both countries were allowed to, or were forced to, work according to the principles of a market economy. This had profound implications for a number of businesses building on the regulated capital market; in particular

Figure 16.7. Wage-Increase and Unemployment in Finland and Sweden (1980-2001)
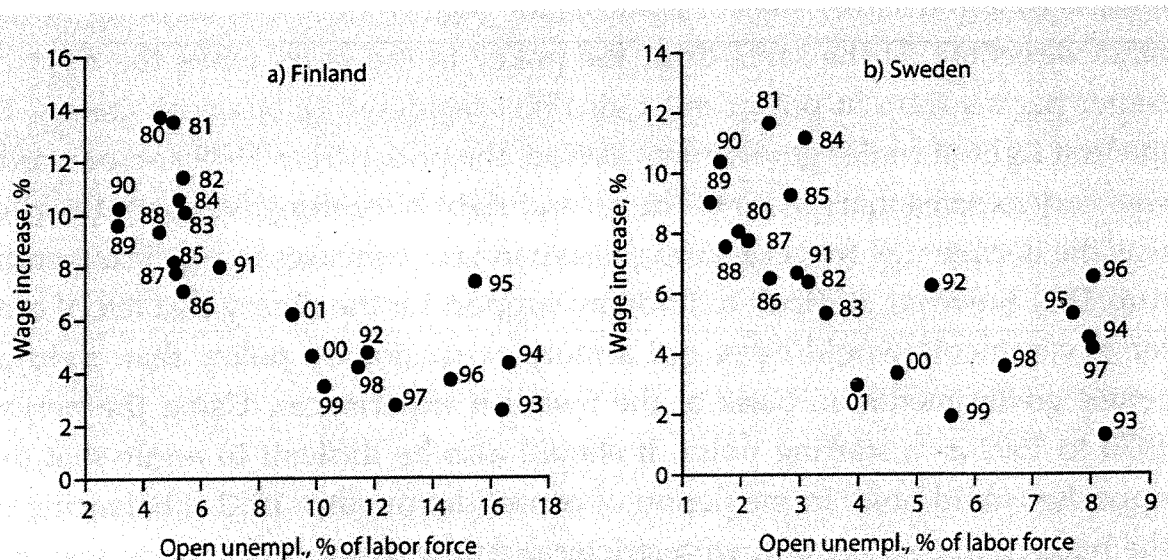
Note: The sources are OECD Economic Outlook and US Department of Labor, Bureau of Labor Statistics.

the housing sector, the construction sector and the banking sector. These lines of business all had considerable problems in both countries during the crisis in the early 1990's. The requirements for profitability in investment activities also became stricter in the entire economy, when the real interest rate went from a value around minus five to plus five in both economies. In Finland, the additional decline in the trade with the eastern countries meant that large parts of the export sector had to adapt to market-economic conditions.

A parallel with the *transition crises* that many eastern economies underwent at that time is close at hand. The trend of the economic activities in both countries also followed the pattern of a deep decline and an ensuing recovery, which was typical of the beginning of the transition phase of the East European economies.

The extent of the decline was most probably also due to the costs for the defense of the currency before the fixed exchange rate finally had to be abandoned. This cost was most certainly highest in Sweden, where the exchange rate was defended for a longer period of time and at considerably higher interest levels than in Finland.

In our context, the depth and the extent of the crisis do raise the question of to what extent too high a cost level did contribute to the crisis. Would the crisis have evolved in any significantly different way, if the adjustment to a lower exchange rate had come at a considerably earlier stage? My own view is that the difference would not have been of great importance for Finland. For Sweden, as we have just seen, the costs of defending the krona in the form of very high interest rates for an extended time contributed to a deepening of the crisis.

In retrospect, it is obvious that the defense of the Swedish krona was futile after Britain had left the ECU. If Sweden had devaluated at this point in time, the long period of defending the krona with exorbitant interests would not have occurred and the crisis in the financial sector would probably not have been as deep as it turned out to be either. This, in turn, would have paved the ground for a more modest decline in the entire Swedish economy.

A very important result of the deep decline for both Finland and Sweden was that both countries experienced a swift and strong disinflation. Only in one year during the 1980's did the Finish wage increases fall below 8 percent. As late as in 1989, the wage increases amounted to about 10 percent. Two years later, in 1991, they amounted to about 2 percent. The picture is similar in Sweden, even if the decline in the wage increases is less apparent here. The decline in the labor market was not as deep in Sweden as in Finland either. The question to be asked is whether a less deep decline would

have created a sufficiently strong disinflation to break the devaluation cycle in the way it actually occurred.

STABILITY FOREVER?

The devaluation cycle was connected to what in retrospect appears to be a failed fixed exchange rate regime. Both Finland and Sweden abandoned this regime in connection with the crisis in the 1990's. Thus, the cyclical pattern we have surveyed here will hardly recur. However, it might naturally be the case that those forces that created the devaluation cycle still exist or will reappear. Finland and Sweden would thus once more risk macroeconomic instability. However, it would most likely manifest itself in ways different from the devaluation cycles studied in this article. Finally, we will discuss this question by returning to the factors that we have earlier pointed out as being the driving forces of the devaluation cycle.

The first question is then whether the *risk of wage inflation* has now been averted. In connection with Figure 16.7, we found that the rate of the wage increases in both countries was considerably dampened after the crisis in the 1990's. In both countries, unemployment had also been driven up above the NAIRU. This has been most obvious in Finland. Thus, there are also conditions for a more stable wage formation process than earlier. The important question is naturally whether this situation will last. It can be found that both countries have made changes in the regulations and institutions, which counteract new outbreaks of wage inflation. For Finland, the adoption of the Euro means that all ideas, that high wage increases will be *bailed out* by devaluation, have disappeared. This should have a cooling effect on both wage formation in the labor market and a government that might have planned to reduce unemployment below NAIRU by an expansionary policy. In addition, the stabilization pact within the Euro should counteract this kind of excessive fiscal policy, which earlier contributed to driving up the price- and wage inflation.

Within the framework of the second stage of the EMU, Sweden has also carried out a number of changes that increase the macroeconomic stability. The most important ones are that the Riksbank has obtained an independent position according to the constitution, and that new regulations for the fiscal policy have been introduced. Thus, by changing the regulations for parliamentary decisions, the government position has been strengthened when it comes to controlling government expenditures. A long-term ceiling for government expenditures has been introduced as part of the same reform.

Moreover, there is a target for the budget balance to be on average two percent of GDP over a business cycle. These measures decrease the risk for new outbreaks of wage inflation. At the same time, it is a fact that despite the cooling, wage increases in Sweden are still at a somewhat too high level compared with the trend in our most important rival countries. While much speaks in favor of these countries being able to keep the wage trend under control also in the future, the Swedish trend in particular emphasizes the importance of the ambitions to reduce unemployment being carried out by measures for reducing the NAIRU and not through an expansionary economic policy.

The second question is whether the *need for continuous reductions in the real exchange rate has disappeared*. This question seems considerably more difficult to answer than the previous one. As far as I know, neither Sweden, nor Finland have carried out any research aiming at explaining the trend described in Figure 16.1 (Charts a and b). A simple overview of the figures hardly provides any material for talking about a break in the trend for either of the countries. In both countries, the yearly decrease in the real exchange rate is about 1.5 per cent per year. In a historical perspective, this trend is due to the recurrent devaluations/depreciations we have analyzed in this article.

For Finland, the possibility of making independent depreciations no longer exists. The question is thus whether the trend indicates that adjusting the Finnish economy to the adoption of the Euro will be a great problem. A study of Figure 16.8 on page 306 does not indicate that this would necessarily be a great problem. Considering the Euro countries as a whole, the real exchange rate has also shown a falling trend. Seen over the entire period, the decline amounts to 1.2 per cent per year. The difference between 1.5 and 1.2 percent could hardly be a cause for concern. In adopting the Euro, the Finnish economy can be expected to become increasingly integrated in the Euro area. Thus, a further convergence in the real exchange rate trend can also be expected.

The analysis for Sweden is similar. The difference in the trend of the real exchange rate is small. Thus, it should be possible for the krona to keep in step with the Euro in the long run if Sweden can keep wage inflation under control. If Sweden adopts the Euro, the Swedish situation in this respect will be similar to that of Finland. Also in the case of Sweden can we in this case expect a convergence of the real exchange rate to the Euro area.

Figure 16.8. Relative Unit Labor Cost in Finland, Sweden and the Euro-Area (1970-2001)
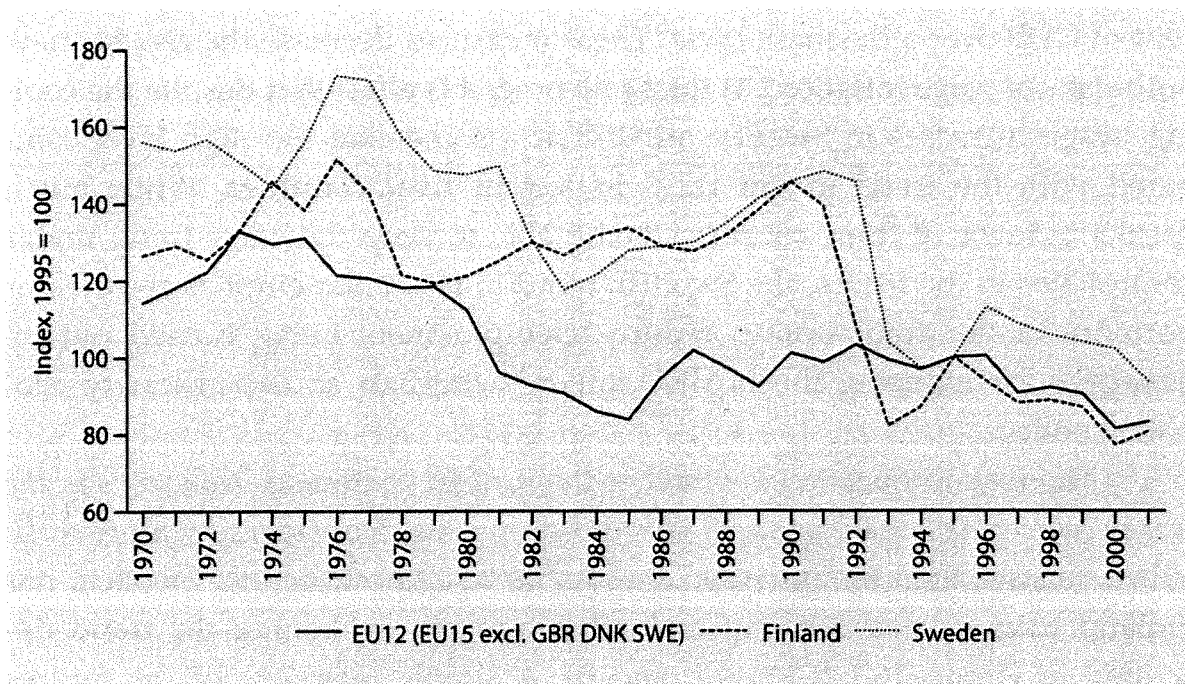
Note: The source is OECD Economic Outlook.

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ENDNOTES

[1] Both devaluations took place in the fall, and thus only had a full impact on the figures for the whole year in the following year.

[2] For an estimation of the automatic stabilizers in the Nordic countries see Braconier & Holden (1999).

[3] See, e.g. Holmlund (1990).

[4] OECD (1989).

[5] See Holmlund (1990) and Wadensjö (1987).

[6] The negotiations between the government and the social partners were carried out at the government castle of Haga.

[7] For a review of the wage agreements in Finland after WWII see Eriksson, Suvanto and Vartia (1990).

[8] Such an analysis is included in Lindbeck (1997).

[9] See e.g. Kiander and Vartia (1996).