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The Finnish Stock Market: Recent Trends and Important Events

1. INTRODUCTION

Finnish financial markets have faced several major changes during the last few decades. Probably the most profound changes have come from the general internationalization and deregulation process that began in the early 1980s – a few years later than in the rest of the Nordic countries. This process took nearly a decade and proceeded gradually from the liberalization of the money market to the abolishment of all restrictions on capital movements to and from Finland. One of the last steps on the liberalization process was taken in 1993, when the restrictions on foreign ownership of Finnish stocks were removed.

Especially the last decade has been a period of rapid growth and development in the financial sector. The total value of financial assets has grown manifold. Derivative markets have been developed and mutual funds started their operations. A large number of new financial instruments have become available for investors. At the same time the amount of financial transactions in different markets has grown making the financial markets more efficient.

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The Finnish economy has also experienced a major restructuring. After a prolonged period of economic growth Finland was hit by a severe recession in the early 1990s. Export demand from the Soviet Union collapsed. Aggregate growth came to a halt and GDP fell sharply in 1991 and 1992. The economic crisis was also reflected in asset prices. Stock prices lost almost three fourths of their value. Since 1993, however, the economy has shown strong signs of recovery.

This paper surveys institutional changes and general economic trends of major importance for the development of the Finnish financial markets, especially the equity market, since the beginning of the seventies. The purpose of the paper is to provide background information that could facilitate the reading of the research surveys published in this special issue of the Finnish Journal of Business Economics.

The remainder of this paper is organized as follows. In section 2 we present a brief outlook for the Finnish economy during the last few decades. In section 3, we present an overview of the Finnish financial markets the main emphasis being on equity market In addition, we discuss several other relevant topics, namely the growth of the mutual funds, and the recent changes in the securities settlement system and in the taxation. The final section offers some conclusions and discusses future directions for Finnish financial markets.

2. A BRIEF OUTLOOK FOR THE FINNISH ECONOMY

Economic development in Finland in the last few decades has been characterized by the trends in two main areas. On the one hand the economic development has had a major effect on the Finnish economy and, in particular, the economic crisis in the early 1990s followed by the crisis in the banking sector. On the other hand, the general liberalization of the trade and the European integration processes have also had a major impact on the Finnish economy.

The average annual GDP growth in Finland during the period 1860–1985 was of the order of 3 per cent in real terms. By international comparison, this represents particularly rapid growth. After the Second World War the gross domestic product never declined in a single year. This transformed Finland from a poor agricultural country into an industrial and service economy with a high standard of living. However, in 1989–1992 Finland faced a severe economic crisis. During 1990–93 the GNP declined by nearly 12 per cent (cf., Figure 1a), and the unemployment rate jumped dramatically (cf., Figure 1b).

The Finnish banking sector has also gone through a major restructuring during the last few decades. The economic crises in the early 1990s together with the attempt of households to drive up their saving led to a credit recession. The liberalization process had opened Finnish markets to international competition a few years earlier, which together with falling securi-

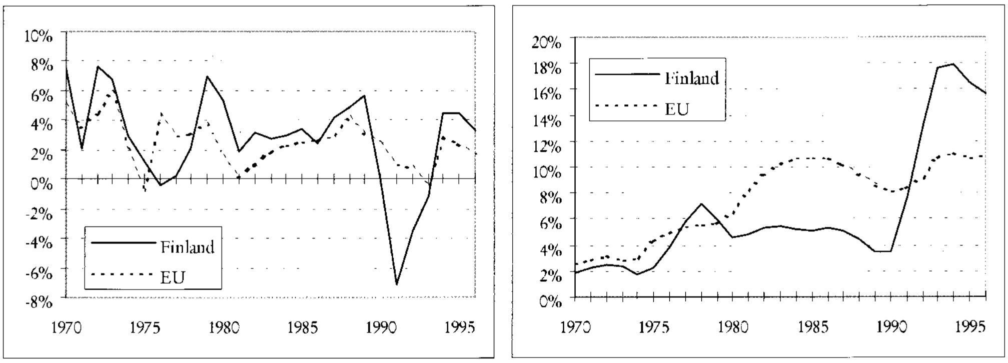


FIGURE 1a. Production (yearly change in the GDP %). FIGURE 1b. Unemployment rate (% of workforce).

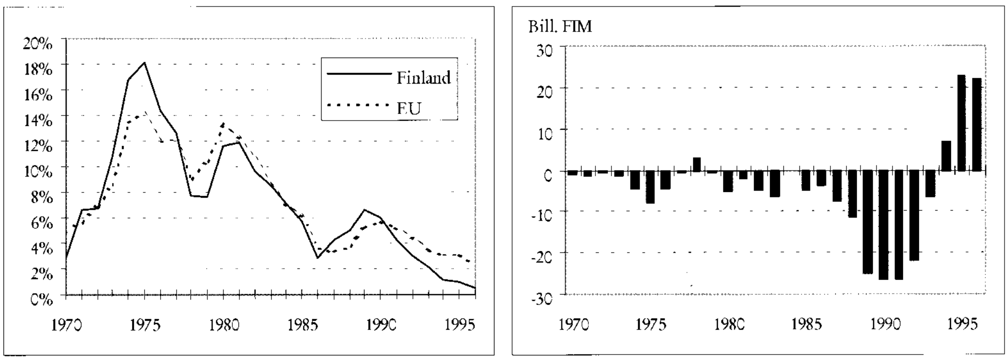


FIGURE 1c. Inflation (yearly change in CPI %). FIGURE 1d. Current accounts (full year, bill. FIM.).

ty prices and company profits, high interest rates and the credit boom in the mid-1980s, led to a banking crisis in Finland similar to other Nordic countries. The crisis required government support to ensure the stability and functionality of the banking system.[1] The amount of capital used to manage the banking crisis comes to FIM 55 billion, which amounts to about 11 per cent of Finnish GDP (Malkamäki and Vesala, 1996). Although banks' profits are recovering from the crisis, the securitization of the financial claims has reduced the major role played by the banks earlier.

The inflation rate has been generally higher in Finland than in other western countries. A level shift in oil prices caused a global increase in the inflation in the early 1970s which was also reflected in Finland (cf., Figure 1c). Although the inflation rate dropped slightly after the

1 For more information on the economic crisis and the general economic development in Finland see, e.g., Bourdes (1993), Currie (1993), and Söderström (1993).

first oil crisis, it remained quite high until the early 1980s when inflation started to decline. However, in the end of 1980s inflation to accelerate again while short-term interest rates remained high and the monetary conditions were tightened. More recently, the inflation rate in Finland has slowed considerably and 1995 Finland exhibited the lowest inflation rate among the EU countries.

The Soviet Union was an important trading partner for Finnish firms until the end of the eighties. In the beginning of 1980s, the Soviet Union's share of the total trade was close to 30 per cent. Since this trade was organized as bilateral clearing trade with decisions made by highly ranked politicians it guaranteed an important presence of the government in the running of the Finnish economy. The clearing system gave Finland a great benefit during the seventies when the price of oil rose considerable and most other western countries were facing increasing trade deficits. However, in the end of 1980s the breakdown of the Soviet Union required substantial adjustments in Finnish production when the export demand from the Soviet Union had to be replaced. This led to a major deficit in the trade balance and on the current account (cf., Figure 1d).

Finland has also taken several steps towards the liberalization of trade and to participate in the European integration. A major step in this process was the signing of a free-trade agreement between the European Economic Community (EEC) and Finland 1972. Ten years earlier in 1961, Finland had already become an associated member of EFTA and in 1985 Finland became a full member of the organization. Beginning in 1992, Finland and other EFTA members (except Switzerland) formed together with the European Union a new free trade area, called the European Economic Area (EEA). On January 1, 1995 Finland became a full-fledged member in the European Union. At the same time the membership in the EFTA was terminated.

3. FINNISH FINANCIAL MARKETS

3.1 General

Finnish financial markets have developed rapidly during the past two decades. In the beginning of the 1980s they were still underdeveloped compared to other major western countries. The Finnish financial system was tightly regulated (e.g., interest rates were not commercially determined) and Finnish financial markets were isolated from international capital markets (e.g., capital movements to and from Finland were rigorously controlled).

However, banks and companies became more and more internationalized and this made it easier for them to circumvent the regulations. Domestic reasons were also favorable for deregulation; the regulated interest rate did not change in response to changes in inflation, producing a relatively long period of negative real interest rates. This led firms to look for more

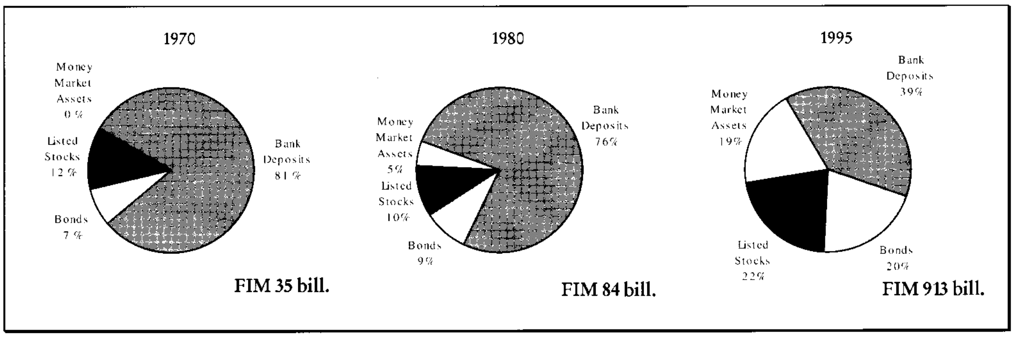


FIGURE 2. Financial assets, nominal value by assets in 1970, 1980, and 1995

profitable opportunities to invest their cash reserves while at the same time there was an unsatisfied demand for loans. This contributed to the birth of the unregulated money market. The pressure against the regulation increased and the gradual abolition of the official regulation and financial market liberalization began in the early 1980s.

This liberalization and internationalization process had major effects on the financial markets. The lifting of restrictions on foreign investments expanded the size and liquidity of the financial markets in Finland. The total value of the financial assets grew more than 20-times from 1970 to 1995 (cf., Figure 2). On the other hand, the development led to a restructuring of the financial markets. The relative size of the stock, money, and bond markets has increased at the expense of bank deposits.

The deregulation process and corresponding changes in the legislation created opportunities for new financial innovations and instruments. For example, convertible bonds were introduced in the beginning of 1980 and loans with warrants in the mid-80s. Derivative markets and mutual funds started their operations in the late 1980s, though the asset market crash made their first few years difficult. In addition, the privatization of major Finnish government owned companies through the stock market increased the value and liquidity of the stock exchange. Furthermore, the active participation of the government in the bond market brought new long-term debt instruments to the market, which increased the liquidity and size of the bond market as well.

3.2 Stock Market

The trading of shares in Finland is concentrated on the Helsinki Stock Exchange (HSE). The HSE was founded in 1912 and has subsequently operated virtually without interruption. The

2 For more detailed information on the recent general changes in the Finnish financial markets, see Malkamäki and Vesala (1996).

Exchange was previously organized as a nonprofit cooperative but was reorganized in November 1995 as a Limited Liability Company.[3] During 1997, a merger agreement between the Helsinki Stock Exchange and SOM (Finnish options exchange) was announced. They will join their operations in a new exchange called as HEX Ltd., Helsinki Security and Derivatives Exchange, Clearing House.

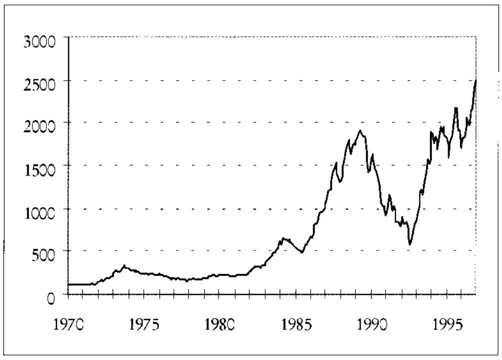
Shares are also quoted on the OTC and brokers' lists. The brokers' list was set up in the summer of 1981 and the OTC list in 1984. These lists were maintained by the Finnish Association of Security Dealers. In August 1996, both the OTC and brokers' lists were transferred to the Stock Exchange. The OTC and brokers' lists are much smaller than the Official List. At the end of 1996 the respective number of companies were 31 and 14 (official list 71) and the market values 3.1 and 4.3 billion markka (official list 285 FIM bill.). Beginning in 1994 mutual funds were also listed on the Helsinki Stock Exchange's list of mutual funds.

A few major interrelated processes characterize the history of the Finnish stock market during the last few decades. The general liberalization and internationalization processes have given foreign investors increased possibilities to buy Finnish shares. The tax disadvantage of the equity investments was first reduced during the 1980s and early 1990s, and finally removed in 1993, when a standardized tax was levied on all capital income. In addition, technical, informational and regulatory development has reshaped the HSE into an internationally competitive stock exchange.

Market capitalization values and trading turnover developed favorably during the 1970s and early 1980s (cf., Figures 3a and 3b). The deregulation process and rapid economic growth caused an unprecedented market boom in the late 1980s. Then came the deep economic recession and the consequent fall in stock prices and trading. New equity issues also ceased almost completely (cf., Figure 3c). The negative development in the stock market continued until mid-1993 after which the stock prices rose rapidly and surpassed the pre-recession level. This was partly due to the success of Nokia Corporation, which accounted solely for almost 24 per cent of the total market capitalization value of the HSE in the end of 1996. At the end of 1996 the number of companies listed in the official list of the HSE was 71 and the number of separately quoted issues was 95.[4] More than ten of the listed companies were also listed on foreign stock exchanges. The total market value of the companies quoted on the official list was 285 billion markkas.

3 For more information of the early history of the Helsinki Stock Exchange see Stjernschantz (1987). Additional information of the Helsinki Stock Exchange and the recent development can be found from Suomen Pörssisäätiö (1987), Hedvall (1994), Kauko and Saukkonen (1996).

4 The number of listed stock series is higher than the number of companies since several companies have two common stock classes listed – the ordinary and the preference share series. They differ typically by their amount of voting rights and/or rights to monetary distributions. Maximum difference in voting rights is set by the company law and it is currently 1:20.



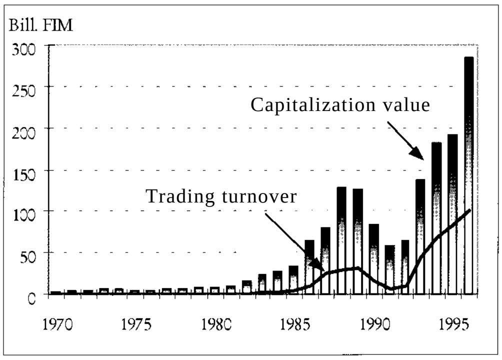
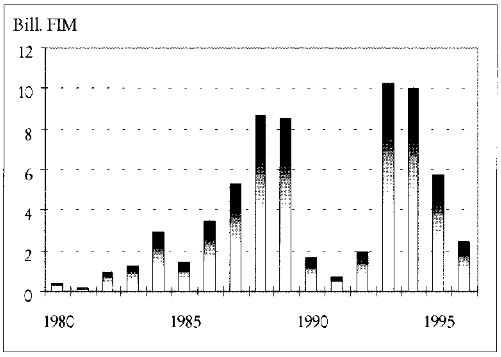


FIGURE 3a. Stock prices development on the Helsinki Stock Exchange 1970–1996 (28.12.90=1000). Unitas-index is used before 1986 and Hex-index after 1987. FIGURE 3b. Trading turnover and market capitalization value 1970–1996 (bill. FIM).

The beginning of the internationalization process in the Finnish stock market can be traced back to 1984[5], when the foreign interest in Finnish shares had grown so great that the HSE decided to list the unrestricted shares separately. At that time the proportion of unrestricted shares was restricted to 20 per cent of the equity capital. In late 1984, the transfer duty (1.6 per cent) was removed for trades where both parties to the trade were foreign. In 1986 Finnish investors were given permission to invest abroad. In April 1987, the maximum of unrestricted equity capital for Finnish firms was raised to 40 per cent on the condition that the amount of voting power



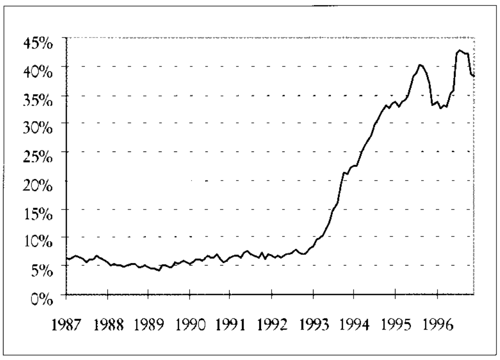


FIGURE 3c. New issues 1980–1996 (bill. FIM). FIGURE 3d. Percentage of market capitalization value owned by foreigners 1987–1996.

5 In 1982, the first Finnish companies were dual-listed on foreign stock exchanges. In 1985, the first foreign companies were listed on the HSE. For more information on the listings of Finnish firms in foreign stock exchange, see e.g., Pursiainen (1997).

on unrestricted shares could still not exceed 20 per cent.[6] The final step in the liberalization process was the abolishment of all restrictions on foreign ownership beginning in January 1993.

The liberalization process has increased foreigners' interest in Finnish stocks. The proportion of market capitalization owned by foreigners has increased rapidly from less than 10 per cent to above 40 per cent (see Figure 3d). At the same time Finnish investors have increasingly diversified their stock portfolio abroad. This together with the higher number of companies listed in foreign stock exchanges has increased the integration with the global capital markets (cf., Nummelin and Vaihekoski, 1996).

The technical development of the trading and settlement system in the Helsinki Stock Exchange has also developed considerably in the last ten years. The switch to the automated and real-time HETI trading system began in early 1989 with 20 shares. In April 1990, all shares were transferred to the HETI system. Earlier trades were carried out on the premises of the stock exchange using the calling out system. The switch to the paperless book entry system began in March 1991 and at the end of 1996 most of the companies had transferred their shares into this system (65 of 71 listed companies). At the same time, the number of trading members of the exchange had increased from 10 (1970) to 22 (1996).

The governance of the Helsinki Stock Exchange has also gone through a major overhaul during the 1980s and 1990s. Self-regulation prevailed until the late 1980s. A new Securities Markets Act came into force in August 1989. Since then it has been amended several time. This legislation is supplemented by decisions made by the Ministry of Finance and regulations and instructions issued by the Financial Supervision Authority. Recent changes in the law and in the HSE self-regulation include, among other things, the introduction of the surveillance list at the beginning of 1994 and of the insiders register after the amendment to the Securities Market Act in 1996. Beginning in August 1996, the Finnish legislation was further amended to comply with European Union directives relating to investment services and market risks. The recent changes in the Finnish equity market are summarized in Figure 4.

3.3 Money Market

Before the 1980s the interest rates and the bank competition was tightly regulated by the Bank of Finland.[7] Loans were usually based on the base rate set by a Parliamentary banking com-

6 See Haavisto (1989) for more information.
7 The origin of this regulation is 1931 when the banks were allowed to make an agreement on a deposit rate. Lending rates were kept stable under a voluntary agreement made in 1941. Interest regulation was reduced in 1960, when banks were allowed to use different rates for different loans, as long as the average lending rate was within a pre-specified limit. In 1975, Bank of Finland founded the call money market, where commercial banks could lend money to fund the deficit in their liquidity. The call money rate became the most important source of central bank funding and the first real money market rate in Finland (Tarkka, 1988).

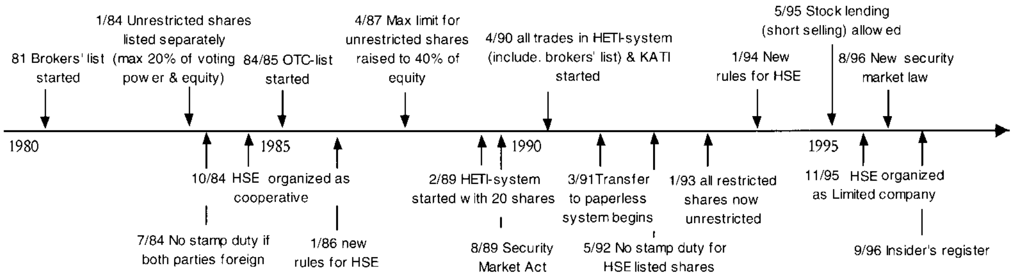


FIGURE 4. Largest changes in the Helsinki Stock Exchange 1980–1996.

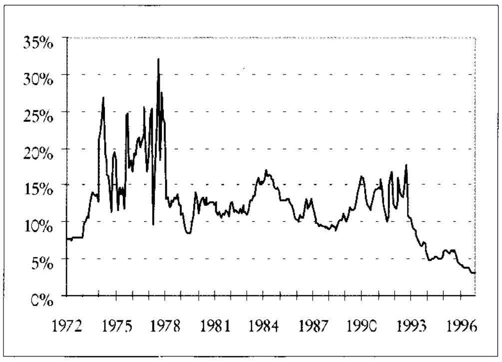
mittee. However, when the financial situation became more turbulent during the 1980s, it became obvious that the static interest rates are unable to reflect the fluctuating financial situations.[8] This lead to the deregulation of banks' lending rates and the banking sector. It began gradually 1982 when foreign banks were allowed to operate in Finland. During the same year Finnish banks received permission to issue certificates of deposits (CDs).

However, a properly functioning secondary market for the CDs, however, did not emerge until the beginning of 1987. In March 1987 the Bank of Finland introduced open market operations and started to participate in the Interbank markets. The Interbank markets shortly became the most important short-term money market in Finland. Ultimately, these money market rates, i.e. HELIBOR-rates (Helsinki Interbank Offered Rate), superseded all other money market rates as the reference rates for company loans.

Although money market rates are available even before 1987, the Central bank started to calculate and publish these money market rates officially beginning in May 1987. HELIBOR-rates are averages for the bid rates for certificates of deposit quoted by the five largest banks each day at 1 p.m.[9] Finnish Central Bank calculates official Interbank rates for five time-periods, namely one, two, three, six, and twelve months. All rates are taken from Reuters-screen and quoted on a per annum basis.[10] Beginning in 1988, floating rates were allowed for all loans. Currently, most of the new short-term company loans are tied to HELIBOR interest rates. The trade volume and the value of the outstanding bank certificates of deposits have risen steadily. At the end of 1996, the total value of CDs totaled nearly 200 billion markkas.

Short-term interest rates remained high during the whole 1980s and early-1990s (cf., Fig-

8 In addition, there were already market born attempts to evade the regulation and restrictions on loan rates. Banks set up financial companies to loan money on more flexible terms. The size of the unregulated money market also started to increase. The largest companies were also able to resort to European money markets.
9 From 1994 forward the rates are calculated as the average of the quotations excluding the highest and the lowest given by the five largest banks.
10 For more information of the Finnish money markets see Lahdenperä (1995), Valtonen (1996), and Niskanen (1996a).



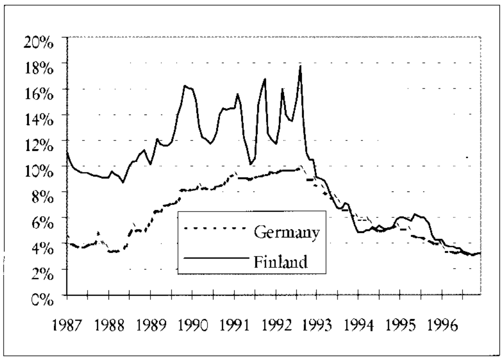


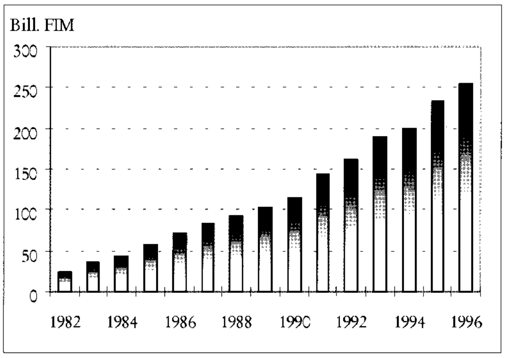
FIGURE 5a. Three-month HELIBOR-rate in Finland 1972–1996 (before 1987, rate calculated from three-month Eurorate on Finnish markka, cf. Malkamäki, 1993). FIGURE 5b. Three month interest rate in Finland (Helibor) and Germany (Fibor) in 1987–1996.

ure 5a), partly due to the high inflation and strong growth in money supply but also because of the continuing devaluation pressure against the Finnish markka. The short-term interest rates remained high until the floating decision in late 1992 after which they have declined considerable. The difference in relevant European and Finnish short-term interest rates has also narrowed after the floating decision (cf., Figure 5b).

3.4 Bond Market

The size and significance of the bond market in Finland have grown steadily during the past few years. The primary bond markets begin to expand already in the 1980s (cf. Figure 6a), but the secondary market remained in a rather underdeveloped state until the 1990s. There are several reasons behind this, the main reasons being still the relatively modest amount of the outstanding bonds, the heterogeneity of the terms applied, low interest on the liquidity of markets (from the part of the issuers), and rather low demand for the bonds.

However, the economic crisis together with strongly deficit government budgets caused the state to borrow increasingly from the domestic and foreign capital markets to cover the budget deficit (see Figure 6b.). The government changed its policy, and begun to actively participate and guide the bond markets. In addition, foreign investors were allowed to buy markka-denominated bonds with a maturity longer than one year in the beginning of 1990. This has contributed to the development of the more efficient government bond markets in the 1990s. The number and size of initial bond issues have also grown together with the secondary market. The total value of outstanding markka was more than 250 billion markkas in the end of 1996.



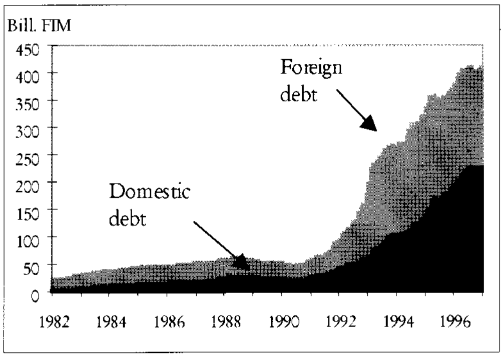


FIGURE 6a. Outstanding markka-denominated bonds 1982–1996 (bill. FIM). FIGURE 6b. Foreign and domestic government debt (bill. FIM).

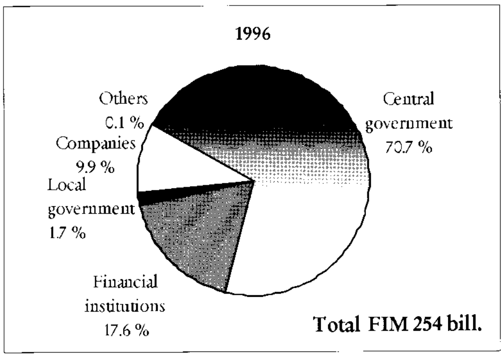


FIGURE 6c. Breakdown of the markka-denominated bond base at the end of 1996.

The bond market, besides growing rapidly and becoming more liquid, has also undergone some significant structural changes. Firstly, the secondary market trading that took place earlier mainly in the HSE has moved to the direct Interbank trading between the brokers. In addition, the increased participation of the government has meant that the government bonds now account for most of the outstanding value of the bonds, whereas the market was previously dominated by the corporation bonds (cf., Figure 6c).[11]

3.5 Liberalization of Capital Movements and Foreign Exchange Market

Strict regulation of the capital movements to and from Finland started in 1939. Earlier Finland was one of the most liberal lands in its foreign exchange markets. The tight capital movement

11 For more information of the Finnish bond markets, see, e.g., Valtonen (1996), and Niskanen (1996b).

regulation lasted until the beginning of the 1980s when the gradual abolition of the exchange controls started. The first step was taken when Bank of Finland gave banks rights to make currency forward agreements in 1980. The last restrictions were removed in the beginning of the 1990s.[12]

The Finnish currency – the markka – was tied to gold until the Bretton Woods system collapsed in 1971. After this, a central exchange rate system (so-called Smithson-agreement) was followed until the continued decline of the U.S. dollar made the system impossible to sustain. After 1973, the markka was tied to the currency index that was calculated as the trade-weighted average of a basket of currencies with more than one per cent of Finland's foreign trade. Beginning in 1984, only convertible currencies were used in the currency index. The Bank of Finland was committed to keep the index within the pre-specified limit. This index was given up in June 1991 when the markka was tied to the European Currency Unit. This reduced the movements of the markka relative the European currencies, but the movements against the US dollar and Japanese Yen became stronger. This regime lasted until September 8, 1992, when the markka was allowed to float. Finally, October 12, 1996 the markka entered the exchange rate mechanism (ERM) of the European Monetary System bringing an end to the floating of the Finnish currency.[13]

The history of the Finnish currency is characterized by a cyclical appearance of devaluations. The markka was devaluated seven times between 1970 and the floating decision in 1992.[14] Figure 7 shows the development of the Finnish markka using the Bank of Finland's trade-weighted currency index. Although the markka was also revalued several times, the devaluations were larger in magnitude and caused the markka to weaken throughout the 1970s and 1980s. The situation culminated in 1992, when the pressure against the markka increased again while politicians were reluctant to devaluate again so shortly after the large devaluation in 1991. The pressure grew so big that there was no alternative but to let the markka float. However, only a few years later in 1993 and 1994, the trust in the markka returned and in the wake of the Finnish economic recovery the markka strengthened back to the level prevailing before the markka was allowed to float.

12 For example free short-term capital movements were allowed from the beginning of 1991 and foreign exchange borrowing was allowed for households at the end of 1991. For more information on exchange controls in Finland, see Lehto-Sinisalo (1992).

13 For more information of the development in the Finnish currency market see, e.g., Bordes (1993) and Autio (1992).

14 The exchange devaluations and revaluations of the markka after 1970: 21.12.70 2.4% revaluation against USD, 15.2.73 5.1% revaluation against USD, 5.4.77 5.7% devaluation, 1.9.77 3.0% devaluation, 17.2.78 8% devaluation, 21.9.79 1.3% revaluation, 25.3.80 2% revaluation, 6.10.82 4.3% devaluation, 11.10.82 6% devaluation, 16.5.86 1.6% devaluation, 17.3.89 4% revaluation, and 15.11.91 12.3% devaluation.

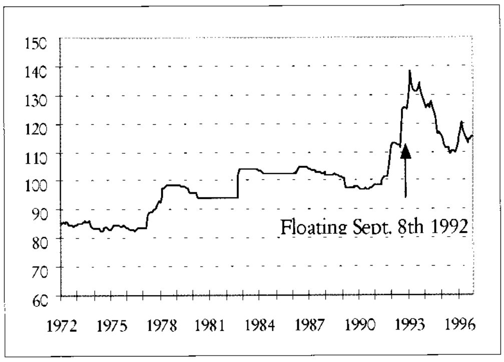


FIGURE 7. The development of the Finnish markka in 1972 to 1996 (currency index, base 1982=100).

3.6 Derivatives Market

In Finland there are two derivatives exchanges in operation: SOM Ltd. and the Finnish Options Exchange (FOEX). Economically, SOM is the more important of the two. The FOEX opened for business in 1986, SOM started in 1987. Earlier there was already some OTC trading offered by the banks. The OTC trading accounts still by far for the major part of the derivatives market (approximately 90 per cent of the total trade).[15]

The beginning of the derivatives exchanges was difficult due to the stock market collapse and diminished total volume of security market trading in the early 1990s (cf., Figure 8a). This led to a market split-up, with SOM focusing on stock-based derivatives and FOEX concentrating on foreign exchange derivatives. Both exchanges have been very innovative and the range of derivative instruments available has increased steadily. Currently, their products include, among others, instruments based on stocks, stock indices, currencies, bonds, and interest rates (cf., Figure 8b). Recent development includes, among others, the introduction of pulp derivatives from in 1996 (FOEX) and electricity forwards in 1996 (SOM).[16]

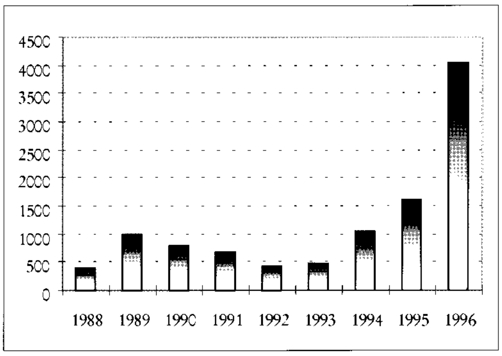
3.7 Other Changes

3.7.1 Taxation

Until the 1990s, bank savings and government bond loads were given preferred tax treatment; the interest income was exempt from tax. This put other forms of investment at a disadvantage since the income they produced was taxed at the investors' marginal rate of tax except for

15 For more comprehensive information of the derivatives markets in Finland see, for example, Virolainen (1996a), and Ahokas, Kuussaari and Virolainen (1996).

16 In 1996, EL-EX Sähköpörssi Oy commenced operations as an electricity exchange. EL-EX is a subsidiary of SOM.



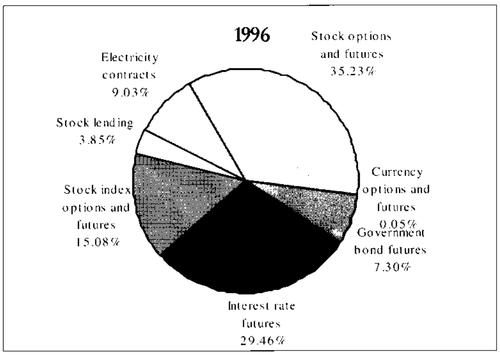


FIGURE 8a. Turnover of derivatives contracts in SOM from 1988 to 1996. FIGURE 8b. Breakdown of derivative contract turnover in SOM 1996.

companies that received the dividend income tax free.[17] In an attempt to equalize the taxation, the profits from sales were exempt from tax if the underlying securities were owned for more than five years. This led to small dividend pay-out ratios and prolonged ownership of the stocks. This all clearly undermined the development of the capital market before 1990s, most notably of the equity market.

During the 1990s, the tax system has gone through a major overhaul that has equalized the tax treatment of different capital incomes. The first major reform was the introduction of the avoir fiscal system in January 1, 1990. Avoir fiscal removed to a great extend the double taxation of the company profits, but the possibility to use various tax deductions was largely reduced at the same time. A year later in 1991, a flat tax rate of 10 per cent was set for all interest received from taxable bank accounts and bonds. Beginning on January 1, 1993, a standardized flat tax of 25 per cent was levied on *all* capital income.[18] Beginning 1996, this rate was increased to 28 per cent.[19]

Foreign investors are generally exempt from the Finnish tax on interest. However, foreign investors pay tax on dividends received in Finland but not for the profits from sales (capital gain). Foreign investors do not have the right to receive the corporate tax credit unless it is allowed in a mutual treaty between the countries concerned. The tax rate on dividends is also determined on the basis of the tax treaty between Finland and the country concerned. If there

17 The advantage was reduced slightly in 1980, when taxpayers were given an ability to deduct a fixed sum from their taxable capital incomes (e.g., dividend and capital gains). However, the level of the deduction was small and clearly aimed for occasional and small capital incomes.
18 Profits from sales were also taxed at this fixed rate. The taxpayer is, however, allowed to use a certain acquisition value supposition if the asset was owned for certain length of time that could be higher than the real acquisition price and thus reduce the taxable profit from the sale.
19 During 1993, the tax rate was 20 per cent for income from taxable bank accounts.

is not such treaty, the tax rate is 28 per cent. Foreigners have also been exempt from the general capital transfer tax (previously the stamp duty) beginning in 1984. Stamp duty was removed from *all* share deals beginning on November 1, 1992, if the transaction was made on stocks listed on the main, OTC, or brokers' list of the HSE. The tax on transactions outside the stock exchange has remained at 1.6 per cent, unless the transaction is made between foreign parties.

3.7.2 Mutual Funds

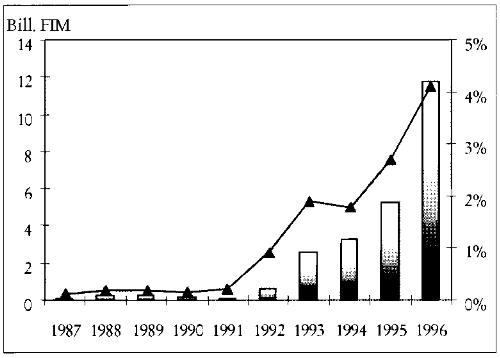
The legislation on mutual funds first came into force in Finland on September 1, 1987. Since then it has been amended several times. The first mutual funds were established in October 1987. However, their beginning was weak due to the fall in asset prices in 1989, the negative development in the economy, and several tax disadvantages. By the end of 1990 only thirteen funds were established and their total value was relatively small. However, following the sharp upward movement in stock prices in autumn 1992 the number and size of the funds grew considerably (cf., Figure 9a). In the end of 1996 the number of mutual funds on the Helsinki Stock Exchange's list of mutual funds was 76.

The liberalization of the financial market and changes in the mutual fund legislation increased the competition in the market and the range of available funds has grown steadily. Especially noteworthy is the strong growth of the short-term money market mutual funds in the mid-1990s (cf., Figure 9b) attributable mostly to institutional investors, who used them for cash-management purposes after the fall in the interest rate level. Although the popularity of the funds has grown, the capital invested in the funds is still relative low by international standards. [20]

3.7.3 Securities Settlement System[21]

Before the 1990s, securities trades were settled directly between the counterparties with the aid of the brokerage company. However, in the spring of 1991 the Helsinki Stock Exchange introduced a centralized settlement system of equity trades based on physical securities (the so-called KATI system). The changeover to a paperless book-entry securities system started also in 1991 and less than a year later the HSE started clearing and settlement of trades in the book-entry securities. During the same year, the Helsinki Money Market Center Ltd. (HMMC) introduced a centralized clearing and settlement system of short-term debt instruments. The

20 For more information on the Finnish mutual funds, see Kasanen et al. (1992), Pylkkönen (1996), and the Annual Report of the Financial Supervision Authority (1996).
21 This section is based on Virolainen (1996b). For additional information of the development of the securities settlement system in Finland, see also Marviala and Palve (1995), and Brusila (1994).



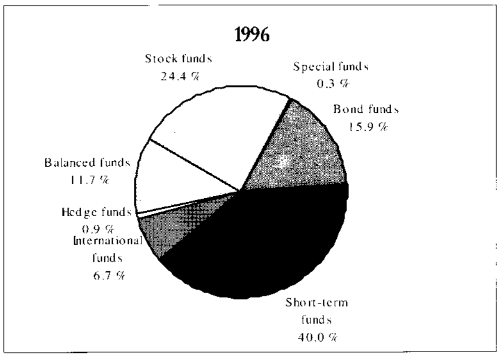


FIGURE 9a. Capitalization value of the mutual funds in Finland 1987–1996 (left scale, bill FIM) and the relative size of their value (right scale; percentage of the equity market capitalization value). FIGURE 9b. Breakdown of the mutual funds' net assets in 1996.

registration system of equity instruments was decentralized and maintained mainly by the banks and the Central Share Register of Finland Cooperative right from the beginning.

However, the growth of trading volumes and internationalization of securities markets soon revealed problems inherent in the decentralized system. Thus, the Finnish Central Securities Depository Ltd. (FCSD) was founded. At the end of 1996 the FCSD acquired the business operations of the HMMC and the Central Share Register of Finland Cooperative as well as the clearing and settlement operations of the HSE. The operations were transferred to the FCSD by a change in the law that became effective on January 1, 1997.

4. CONCLUDING COMMENTS

The last two decades in the Finnish financial markets are strongly characterized by the liberalization and deregulation processes. The liberalization process has given foreign investors free access to participate in the Finnish markets while giving Finnish investors similar possibilities to operate in the foreign markets. At the same time, the deregulation process has given room for financial innovations thus increasing the amount of alternative investment possibilities and instruments of risk management. As a result the size of the financial sector has expanded manifold and become more efficient.

More recently, Finland's decision to join the European Union, the economic integration process within the EU as well as the increasing capital market integration around the world has asked for more efficiency from both the investors and the financial markets. This development together with the plans for a single currency within the European Monetary Union in the beginning of 1999 has called into a question of the existence of national exchanges. Although the number of national exchanges will certainly be reduced, as the recent announcement of the merger between the Helsinki Stock Exchange and SOM reflects, it remains to be seen whether local national markets will survive during the next few decades. ■

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