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# Niche of Cooperative Banking in Finland during the first half of the Twentieth Century

In this article I will analyse the founding phases of the cooperative banking movement in Finland. Especially I concentrate on finding out what kind of comparative advantages the cooperative organisational form had in a less-developed country where the socio-economic structure was rural and the economy was just moving from the barter economy into monetary economy. At that time the lending facilities were quite limited and only those persons who had good real collateral had possibilities to get loans. So, the lack of money was a real hindrance to any economic reforms in the countryside, and for the future of the whole society it was necessary to reorganise the lending facilities.

## 1. FINNISH SOCIETY AND URGENT NEED FOR SOCIAL REFORMS

At the beginning of this century Finland was in many ways an underdeveloped society as you can see in the gdp per capita figures. The Finnish economy had moved into a permanent growth phase during the second half of the nineteenth century, but the growth rate of the population was quite high and compared to Western European countries the standard of living in Finland remained low. (Hjerppe 1996)

GDP per capita in 1900, Finland = 100

Finland	100	Denmark	179	Ireland	154
United Kingdom	283	Sweden	158	Hungary	104

Source: Maddison, (1995)

Most of the Finns were still living in the countryside getting their living from agriculture and forestry. Although migration into cities and urban industries had begun, this movement had only small effects upon the Finnish society as a whole. Only ten per cent of the population of 2.5 million people was living in the cities and the socio-economic structure emphasises the peripheral situation in Finland:

Population by industry in 1900, %

Agriculture and forestry	70
Industry and construction	14
Services	8
Economically inactive persons	5
Unknown	3

Source: Haapala, (1989)

Many people are used to looking at the Finnish countryside through the glasses of our national poet J. L. Runeberg. According to him the rural society was an idyllic paradise where people lived in harmony. In reality the picture was quite the opposite. For the majority of the people in the countryside the living conditions were unsatisfying.

In broad lines the rural population consisted of three groups, which were landowners or farmers, tenant households or crofters and agricultural workers or the landless poor, but actually the real dividing line went between the owning class and the labouring classes.

Peasant population groups in 1901

	Number	%
Landowners	110 000	38
Tenant households	42 000	14
Agricultural workers	<u>139 000</u>	<u>48</u>
	291 000	100

Source: Gebhard, (1913)

Both crofters and especially agricultural workers lived under very hard conditions. Their daily incomes were low and irregular. The views of the future for these poor people were gloomy, which in turn led to the lack of enterprise and laziness in these groups.

Generally speaking, the landowners formed the upper class in the Finnish countryside but actually the situation was much more complicated. The landowners were not any homog-

enous group, far away from it, and only the owners of medium-sized or big farms belonged to this upper class.

Farm size category, arable land in 1901, hectare

Size category	Number	%
1 – 4,99	76 374	36
5 – 9,99	49 414	23
10 – 24,99	56 790	27
25 – 49,99	21 044	10
50 – 99,99	6 225	3
100 –	1 855	1
Total	211 702	100

Source: The Economic History of Finland 3 (1983)

Parcels less than one hectare are excluded  
Both farms cultivated by owner and tenant

A vast majority of all farms belonged to the smallest groups where arable land per farm was under ten hectares. Most farms were too small to give sufficient livelihood to their cultivators and the Finnish agriculture was dependent on income from forests – wages or stumpage prices. As a consequence the biggest social problems were found in the rural sector of the society. There were large numbers of households which lived under the minimum subsistence level, and many people thought that these miserable conditions were a real threat to the cohesion of the society.

At this time about 2.4 million people were living in the rural communities and among these people only a small minority had a secure economic position. At least agricultural workers, most of the crofters and owners of the smallest farms had big economic problems in everyday life. One can calculate that the number of people, children and old-aged included, belonging to these poor groups rose over one million.

Also the representatives of the elite saw that there was an urgent need for very comprehensive social reforms in the rural sectors and land reform was seen as an important part of this reform project.

One of the most active supporters of reforms was Hannes Gebhard who had studied economics and history in Germany and there he had become acquainted with the cooperative movement. After coming back to Finland Gebhard realised that cooperative movement could be a very useful tool in carrying through the social reforms. Also some other influential people had the same kind of thoughts about the needs for social reforms and so the door was open for cooperative movement. This meant the beginning of a comprehensive reform program in which the land reform was only a part. There was urgent need to give the small farmers possibilities

to organise by themselves the selling of agricultural products and buying of seeds, fertilisers and other agricultural inputs. Also the vocational readiness of the citizens was in need of improvement. Solution to these questions was cooperative producer associations. (Alanen 1964)

## 2. CREDIT ISSUES

Credit system functioned quite poorly in the countryside. There were 3–4 credit institutions which gave loans to farmers, but the terms of the loans were very strict. In order to secure the repayment of the loan the borrower must give a collateral to the lender and small farmers or crofters had not suitable collaterals. Besides the collateral ought to be mortgaged which was expensive and in practice suited only to big farms and estates. Another way to secure the repayment was to have a co-signer in a loan but banks accepted only well to-do persons as co-signers and the poor could not find out acceptable co-signers. In fact the majority of the people in the countryside – small farmers, crofters and agricultural labourers – had not access to loans from the official credit institutions. For these people the only solution was to ask loans from private persons but these moneylenders were really ruthless. So, the unsuitable credit system was a real hindrance to any economic progress in the rural sectors of the society. Leading agricultural experts were well aware that before starting any land reform it should have been necessary to reorganise the credit system. In practice this meant the establishing of a new credit institution which would specialise in giving loans for these emerging new small farmers.

Hannes Gebhard got his ideas from Germany, where he had taken part in Max Sering's lectures about agricultural economics and the role of cooperatives in the progress of agriculture. In these lectures Gebhard got acquainted with the name Friedrich Raiffeisen who had founded the first rural credit cooperative in the year 1864. Raiffeisen was an idealistic social reformer who at the same time had quite modern views about credit business. Although nobody used the term asymmetric information or enforcement in the modern context at that time so in Raiffeisen's writings one can see embryonic intuitions about these concepts. (Guinnane, Timothy W – Henriksen, Ingrid, 1998; see also Vihriälä 1989)

Asymmetric information means that the contracting parties in a loan transaction have not equal amounts of information about each other. The borrower can always conceal something about his economic situation and he can misrepresent the purposes to which he intends to use the loan. In banking business asymmetric information is a fact which is impossible to escape. The only way is to try minimising this information asymmetry but it is costly and you can never inspect everything. Banks must use time and money to obtain more information about the borrower before making a lending decision. It is also costly to monitor the borrower afterwards.

The concept enforcement is also connected to the behaviour of the borrower. For the bank it is important to know what the borrower is doing after getting the loan. The borrower must follow the terms of the loan and in this way make sure that the borrower succeeds in the amortisation of the loan. And when the period of amortisation is long this enforcement is still more important to the bank.

Banking business is often called by the term trusting business. Because the banker cannot know everything he must trust in his client. At the same time the client must trust that the banker keeps his promises. The mutual trust between both partners is the best guarantee against moral hazard behaviour.

In the Raiffeisen model one can see the first embryos of this kind of thinking. According to the model the credit cooperatives were very small containing only a small village instead of a parish. The number of members was kept around 20 – 40. In a small rural village all inhabitants knew each other and so the management committee of the cooperative, which was recruited from the members, knew exactly the economic background of the borrower. So the credit cooperatives knew their customers exceptionally well. Cooperatives could escape the problems caused by asymmetric information without any extra costs.

At the same time the smallness of credit cooperatives assured that enforcement problems were minimised. In a small village all people were well aware of the businesses of their neighbours, so, social control was tight between neighbours. The management committee knew automatically how the borrower was using his loan. This tight social control means that there is little room for moral hazard action.

An essential part of this model is a limited or unlimited liability for the cooperative's debts. Thanks to this the requirements concerning the collateral of the loan could be kept at the minimum and the risk of moral hazard behaviour was kept low. Cooperatives had no need to require first class collateral and the co-signers could be recruited also from the lowest levels of the society. Thanks to the cooperative organisational form the field of activity could be widened to include also crofters, agricultural labourers and other not so well-to-do groups in the countryside.

Unlimited liability had another benefit, too. It was substituted for own capital, because members were committed to paying the possible defaults. The members of the cooperatives were not able to pay considerable shares and for the cooperatives it took a long time to increase own capital by profitable operation. By the unlimited liability of the members the cooperatives could speed up the foundation phases.

Without exaggeration one can say that the Raiffeisen model offered a solution to many fundamental problems in all banking operations. However, we must remember that these solutions are not automatically universal. They presume that the scale of operation is small and

the societal conditions are quite static. So, it is easy to understand why the Raiffeisen model suited so well to Finnish rural communities during the decades before the Second World War.

### 3. HOW TO FINANCE THE OPERATION?

The problems caused by asymmetric information and enforcement were mainly resolved but there was another much bigger problem. How to finance the lending activities of credit cooperatives. In the original Raiffeisen model the cooperatives got small membership fees, deposits from members and also from well-to-do persons. However, Finland at the beginning of the twentieth century was a much poorer country than Germany, and the Finnish economy was just moving from barter economy into monetary economy. The members of new cooperatives had not resources to make any considerable deposits, so, there was no hopes of self financing the operation. Gebhard and his friends were completely aware of this fact and they looked for other solutions.

According to their plan the first move was to set up a special central institution for these cooperatives. This central bank, called OKOBANK, would take care of the financing. OKOBANK would first help in setting up local lending associations and then in financing the operation of these local cooperatives. OKOBANK again could turn to the state and loan money from the central government and channel these loans through local cooperatives to the farmers etc. This plan suited the government well as it was at the same time looking for new ways to organise the public agricultural credit. There was room for new enterprises where public and private forces were joined together. So, the cooperative banking movement in its founding years was closely tied to the central government. It was set up by private initiatives but its financing was based on the state and it also got a yearly subsidy from the central government. (Kuusterä)

This solution is in accordance with Alexander Gerschenkron's views concerning the degree of backwardness and the role of the state. (Gerschenkron) His key concepts were the relative backwardness of a country and the role of the state in organising the financing of economic development processes. According to Gerschenkron the more economically backward a society is the more active state is needed to speed up the development process. Although Gerschenkron presented these ideas about forty years ago he is still well known and his views about relative backwardness are fruitful. For example the widely used growth theory – catching up theory – is partly based on Gerschenkron's ideas.

The Finnish society at the end of the nineteenth century was without any doubt underdeveloped compared to its western neighbour countries, and the backwardness was most striking in the rural sectors of the society. Profitability in agriculture was quite low and the lower

levels of rural population lived near the subsistence level. As a consequence possibilities to get private money to finance the agricultural reforms were weak and the only solution was state intervention.

#### 4. CREDIT COOPERATIVES IN PRACTISE

A typical feature in Finland was that in these founding phases the credit cooperative movement began from above not from under as happened in most other countries. First we got OKOBANK, whose shareholders consisted mainly of the upper levels of civil servants and businessmen, and which was strongly supported by the state. This central institution – OKOBANK – was in turn the primus motor in setting up local credit cooperatives. Although OKOBANK was founded first and local credit cooperatives later, the purpose was that local cooperatives redeem the privately owned shares of OKOBANK as soon as they have gathered enough money for it.

Before starting a new credit cooperative the officials of OKOBANK made a minute inspection of the economic conditions of the parish in question. They obtained information about transport connections, demand for agricultural products and the level of monetarisation. After that OKOBANK made the decision on setting up a new credit cooperative. In this way OKOBANK tried to make sure that the new credit cooperatives are viable and capable of repaying its loans from OKOBANK. By the minute inspection of credit cooperatives OKOBANK tried to solve the same problems concerning asymmetric information and enforcement as cooperatives had.

In this context the Finnish credit cooperative movement could utilise Hannes Gebhard's exceptionally good knowledge of the living conditions in Finnish rural communities. Gebhard had been a leading figure in a large project which was set up in order to give material for the land reform. Thanks to this work Gebhard knew very well the biggest social problems in Finnish rural communities and also the regional differences in Finland. (Gebhard 1913)

In spite of this subordinate situation the local credit cooperatives were loyal to the original Raiffeisen model. Credit cooperatives were continually small – usually about 20–50 members – and the voluntary management committee, which was elected by the members, conducted the day-to-day business activities. So, the management was in the hands of the members not in hired hands. When the work burden of the management committee grew it recruited some help. The first hired person was usually a treasurer who also took care of the bookkeeping.

This kind of management is a very vulnerable system because it puts large demands on the educational level of the management committee. In small villages there were, however, only a few educated persons like a teacher and priest. So, most cooperatives were obliged to rely on laymen. Usually they were active farmers.

This in turn meant that OKOBANK ought to put to practice a really comprehensive training program. Thousands and thousands of cooperative activists went through training programs and learnt what bookkeeping is and what kind of loan documents are juridically correct. They were also taught the fundamental principles of banking like minimum cash reserves. Benefits of these programs did not confine only to cooperatives. Also the rural communities got in this way trained persons to manage local matters. One can even say that cooperatives had a very important role in the modernisation process of the whole society. (Kuusterä)

### 5. SPREAD OF THE NETWORK

Thanks to the economic support from the central government the cooperative credit associations could spread extremely fast into rural municipalities. At the same time this indicates that there was a niche for this kind of credit system.

Number of cooperatives ( credit societies)

Year	Credit cooperatives	Loans million marks	Year	Credit cooperatives	Loans million marks
1903	8	0.6			
1904	57				
1905	119	8.4	1925	1233	287.8
1906	143		1926	1344	
1907	206		1927	1399	
1908	262		1928	1416	
1909	336		1929	1415	
1910	370	51.9	1930	1416	1306.3
1911	397		1931	1410	
1912	396		1932	1397	
1913	410		1933	1388	
1914	429		1934	1355	
1915	492	67.3	1935	1299	1633.3
1916	553		1936	1235	
1917	582		1937	1163	
1918	590		1938	1123	
1919	591		1939	1085	
1920	602	30.2	1940	1079	1980.9
1921	672		1945	927	1484.9
1922	831		1950	684	3825.4
1923	928		1955	587	7056.0
1924	1041				

Source: The Economic History of Finland 3 (1983)



At the beginning of the century the number of rural municipalities was about 500, so, the network of cooperatives spread over the whole country in a couple of decades. In the year 1924 we had already over 1000 cooperatives and four years later in the year 1928 the number of cooperatives reached the peak 1416. Now Hannes Gebhard's original wishes had been fulfilled.

The Finnish cooperative movement had developed along the Raiffeisen lines and this brought about also some problems. Undeniably the smallness of the credit cooperatives was a growing headache. In the course of the years the activities of the cooperatives have grown. Especially after the year 1920 when cooperatives were allowed to take deposits also from the public and not only from the members. Now cooperatives were changing from credit associations into real banking institutions and the demands concerning the management grew rapidly. Problems concerning asymmetric information and enforcement could be under control but new problems like the liquidity of cooperatives, juridical issues in banking operations and general managerial issues rose up. It was not any more possible to manage the cooperatives without any permanent personnel.

The smallest cooperatives were, however, so small that they could not afford to hire anybody. So, they were slowly but surely withering away. These problems were strengthened during the depression years at the beginning of the 1930's and the only solution was to amalgamate these small cooperatives into bigger ones. So, the number of cooperatives was reduced by 300 up to 1938.

The niche of credit cooperatives was limited to agricultural credits and compared to other credit institutions the market share was quite modest. However, cooperatives dominated the markets in agricultural credits especially credits granted for small farmers, emancipated ex crofters and so on. In the middle of the 1920's the loan stock of cooperatives rose sharply and this upward trend continued except the short recession in the first years of the 1930's. As Gebhard and his supporters had outlined the cooperative credit movement was to have a decisive role in carrying out the big land reforms of the 1920's.

The links between the cooperative credit movement or OKOBANK group and central government remained quite intimate during these first decades. Deposits in the cooperatives were continuously small, so, they had to rely on state loans which cooperatives got from OKOBANK. This link became still more intimate in the middle of the 1920's when central government intensified its loaning to agriculture. A part of this reform was the strengthening of the capital base of OKOBANK. As a consequence, the share capital of OKOBANK was increased into tenfold and this increase was subscribed by the state. As a consequence, the state became the main owner of OKOBANK.

In spite of this increased state intervention the cooperative movement as a whole tried to

increase its independent status. Local cooperatives got a better hold on the deposit market and as the deposits increased their possibilities to self-finance became better.

#### Financing of cooperative credit societies

Year	Degree of self-sufficiency, % *
1905	1
1910	5
1915	5
1920	35
1925	8
1930	26
1935	35
1937	50

\* Capital + funds + deposits / advances to the public

Source: Kuusterä

The real advance in the cooperative movement or cooperative group began during the 1930's. At that time the cooperatives and their central bank OKOBANK had succeeded in developing the group's physical and intellectual capacities with which it had attained comparative advantage in granting loans to agriculture. The original ideas concerning asymmetric information and enforcement were still alive and the cooperatives were quite successful in risk management. This was clearly seen during the great depression when agriculture was quite severely hit by the depression but the credit losses of cooperatives remained low.

The smallest cooperatives had been amalgamated with the bigger ones and the remaining cooperatives were economically stronger. The fact that by the end of the 1930's local cooperatives had been able to acquire the majority of the share capital in OKOBANK can be considered a good indication of the improved position of cooperatives.

## 6. TEST OF THE SYSTEM

The comprehensive resettlement and colonisation program after the Second World War was a real test to the functioning of the cooperative apparatus. This colonisation project which concerned over half a million people began in the year 1945 and was completed at the beginning of the 1950's. The program was once more financed by state loans and the cooperative group was the main distributor of these colonisation or reconstruction loans.

During the first years after the war the conditions in Finland were quite unsteady. Most banks were not willing to take care of the new borrowers because the banks were afraid of the

risks of granting state loans to new clients. However, the cooperative group was at the first beginning ready to implement this gigantic project. This project had many similarities compared to earlier colonisation projects in the 1920's and 1930's, so, the cooperative group had superior capacity to succeed. Their apparatus knew how to act as an intermediary in granting vast numbers of state loans to private persons. Once more the organisational form of cooperatives was superior in gathering information about new borrowers and monitoring these persons afterwards. By the cooperative organisational form it was possible to diminish the risks concerning asymmetric information and enforcement.

These years of reconstruction and colonisation were a real success story for the cooperative group. In a decade cooperatives granted about 150,000 new loans and the majority of these borrowers became permanent customers for cooperatives. This improved the possibilities of the cooperatives to compete for the deposits. A good indicator of the success is how the market share of the cooperatives behaved. The nearest competitors to the cooperatives were the savings banks. In the year 1938 the deposits were only 18 per cent of the deposits in the savings banks, but in the year 1950 the share had risen to 52 per cent. During these years the cooperative group rose to the same level compared with the old banks. Now the group had finally secured its status as a real banking group. ■

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