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Can large trade shocks cause crises? The case of the Finnish-Soviet trade collapse

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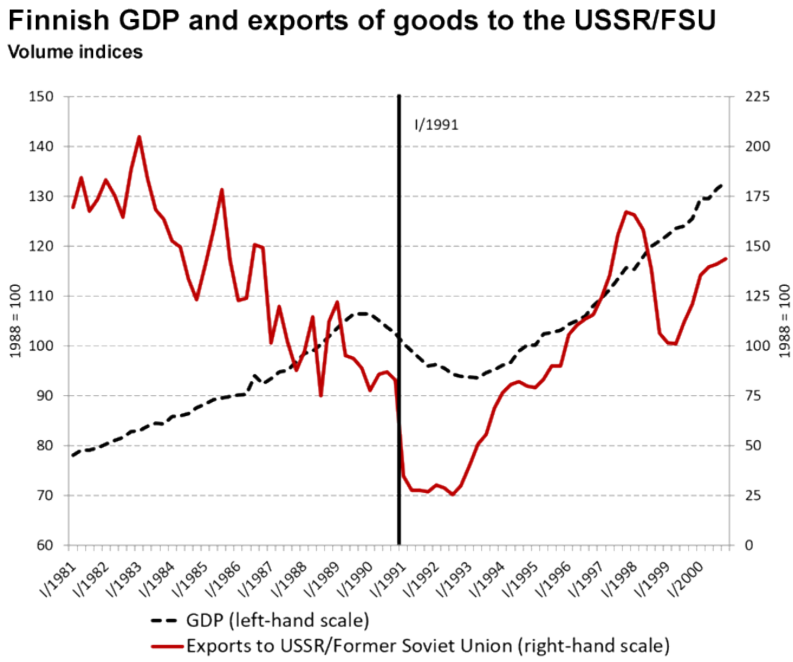
What are the economic causes and consequences of large trade disruptions? Are they able to unleash a full-scale economic crisis? In recent years, the news has been full of events such as the US-China trade war, Brexit and even the collapse of tourism services exports in southern Europe following the outbreak of COVID-19. Finland has its own unique and still recent experience from the early 1990s, when the Soviet Union withdrew from the clearing trade agreement in December 1990.

Finnish exports to the USSR fell abruptly from 2.4 to 0.8 per cent of GDP in winter 1991, in the midst of a prolonged economic crisis, still one of the most severe experienced by an industrialized economy since World War II. In 1993, Finnish GDP was over 17 per cent lower than if it had grown at its average pace from 1989 onwards.

Chart 1.



Source: Statistics Finland.
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Could this trade collapse be the main culprit for the Finnish Great Depression? That hypothesis has received attention among academic economists abroad, notably (Gorodnichenko – Mendoza – Tesar, 2012). Nevertheless, it goes against the assessment of many Finnish economists and much of public memory, which associates the crisis with the collapse of the casino economy, the banking crisis and the end of the hard markka policy.

In a recent paper (Gulan – Haavio – Kilponen, forthcoming) we re-examine the role of the Soviet trade collapse in the Finnish Great Depression. We use elastic statistical techniques that allow us to split the decline in Finnish GDP into various factors that were at play at the time and assess their relative importance. We exploit the fact that the demise of the USSR happened independently from the Finnish economic situation, which makes this episode a rare historical case in which such a cause-and-effect mechanism is clean and easy to isolate.

Our results indicate that the Soviet trade collapse had a considerable negative impact on the Finnish economy. The initial drop of exports equivalent to 1.6 per cent of GDP resulted in an overall loss of GDP amounting to 4.7–5.9 percentage points. Nevertheless, this accounts for only a fraction of the overall drop in GDP. Based on our analysis, the trade shock alone can explain only 27–34 per cent of the cumulative loss in GDP.

Consequently, according to our analysis, the trade collapse could not by itself generate the massive economic downturn witnessed by Finland in the early 1990s. Shocks originating domestically, unrelated to the trade shock, were another, at least as important driver of the Finnish Great Depression, contributing 30–48 per cent of the total loss. In the mid-1980s, Finland underwent a process of deep financial liberalization that contributed to an explosion of credit, swelling leverage and soaring stock and house prices. The financial boom ended with a stock market crash in 2Q 1989, over a year before the end of the Soviet trade. What followed was a wave of bankruptcies and a massive crisis in the banking sector.

Europe, in turn, was experiencing a monetary contraction, leading ultimately to a recession, the Black Wednesday collapse of Sterling in September 1992 and the Exchange Rate Mechanism crisis. Global pulp and paper prices witnessed a multi-year decline as well. All these factors also contributed to the Finnish Great Depression in the early 1990s.

Disentangling the precise role of financial turbulence from other domestic factors, e.g. economic policy, aggregate demand or productivity is a more difficult task. Nevertheless, our earlier work (Gulan – Haavio – Kilponen, 2019) seems to confirm the central role of the unfolding financial crisis, stressed earlier by many Finnish economists (Vihriälä, 1997; Kiander – Vartia, 1996).

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Tags

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