Managing financial deregulation: lessons from the 1980's in the Nordic countries*

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Outline

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II. Close look at the Nordic countries

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III. Central issues in financial deregulation

- Problems in Nordic deregulations
- Lessons

IV. Managing the Nordic financial crises

- Crisis management
- Lessons

I. The aftermath of WWII

- Destruction from the war and earlier instabilities in 1930's.
- Main concern: How to generate adequate savings to fund reconstruction and industrial development.
  - Often focus on priority sectors such as basic industries, exports and the housing sector.
- Regulatory frameworks to protect financial services industry were kept unchanged.
  - Rationing and controls of the financial system
  - Interest rates were kept stable and below the market levels.
  - Public debt levels were very high after WWII.

- Gradual lifting of financial controls.
  - Some marketable financial instruments in 1950's to 1970's (treasury bills, certificates of deposit, commercial paper).
  - Interest rate controls were gradually lifted, especially during 1980s.
    - This led to tightening of interest margins.
    - Time tables differed a lot between countries.
- Other (gradual) developments
  - Deregulation of financial services (fees).
  - Removal of direct lending controls and investment regulations.
  - Strengthening of competition among financial institutions.
  - Financial assistance (low-rate financing, tax incentives etc.) gradually reformed or removed.

I.1 External dimensions

- Exchange controls in some countries in 1930s and in majority of countries right after WWII.
- Fixed exchange rates regime, capital controls.
- Bretton Woods institutions
  - IMF for loan facilities for countries in temporary difficulties.
  - OEEC (later OECD) for trade liberalization.
  - European Payment Union: clearing balances and credit.
- EEC led to liberalization of real economies.
- OECD engaged countries in process of liberalization of capital movements in 1961.
  - Some countries without exchange controls: Canada, USA, Switzerland, Germany (after 1958).

- Breakdown of the Bretton Woods system in 1971.
  - In Europe, creation of the ’Snake’ for exchange rates in 1972
  - The European Monetary System in 1978
    - ERM: fixed and adjustable exchange rates, mutual support
    - Big inflation differentials => realignments in the first years, but few realignments in 1980s.
- Renewed efforts to capital account liberalizations in 1980’s.
  - EU: some countries (Germany, UK, Denmark) liberalized before 1986 EU Directive. Netherlands joined at the end of 1986. France joined in 1988.
- Maastricht Treaty in 1992 made free movement of capital a cornerstones of EU.
  - EMS crisis in 1992-93 led to realignments and wide bands for exchange rates.
  - Road to EMU (started in 1999). New ERM for outsiders. Also floaters (Sweden, UK…)

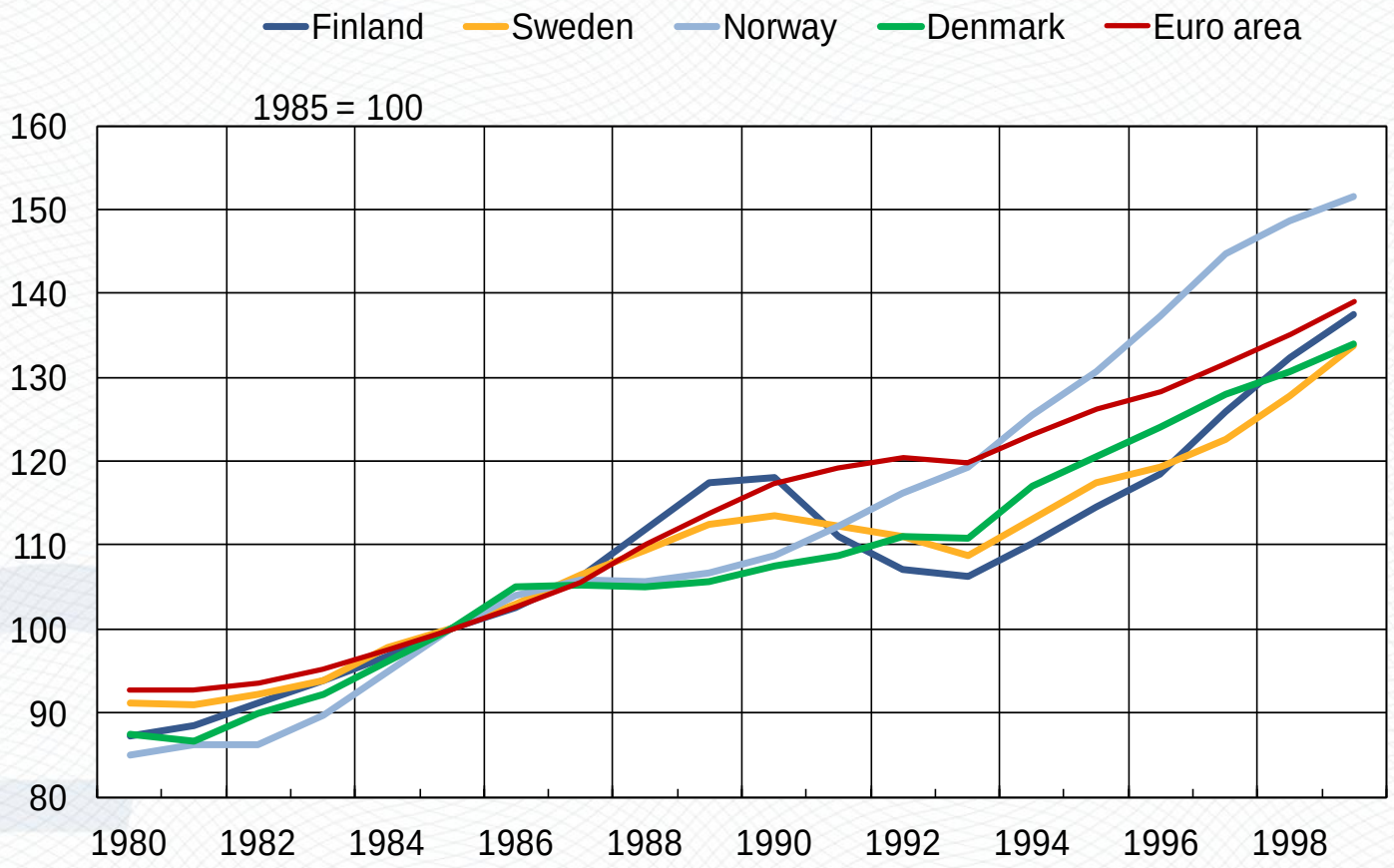
I.2 Liberalization of banking and financial systems

- Timing of domestic liberalization varied among countries.
- EU legislation: important steps from 1989 onward.
  - Single EU banking licence,
  - Single passport for investment services,
  - Single market in financial services etc.
- Banking crises in Europe (before the current one):
  - Problems with individual banks: BCCI, Banesto, Barings, Credit Lyonnaises and various small banks.
  - Systemic banking crises: 3 Nordic countries in early 1990's and Spain in early 1980's
    - among the "big five crises" of advanced market economies before the current crisis (Reinhard & Rogoff)

II. Close look at the Nordic countries

- Why important?
  - Three out of four countries developed very big financial crises from liberalization.
- Background on Nordics:
  - Small open economies, total population over 22 million:
    - Wide-spread ties, e.g., common labor market since 1954.
    - Sweden wealthiest in 1970s, Finland weakest (suffered heavily in WWII).
    - Foreign trade and associated payments liberalized early by the end of 1950's.
  - Egalitarian, socially cohesive countries with democratic tradition:
    - Big public sector, strong influence on the economy.
  - Financial repression was an instrument of growth and industrialization policies.
    - More rapid inflation than in much of the western world.

GDP



Source: Eurostat.

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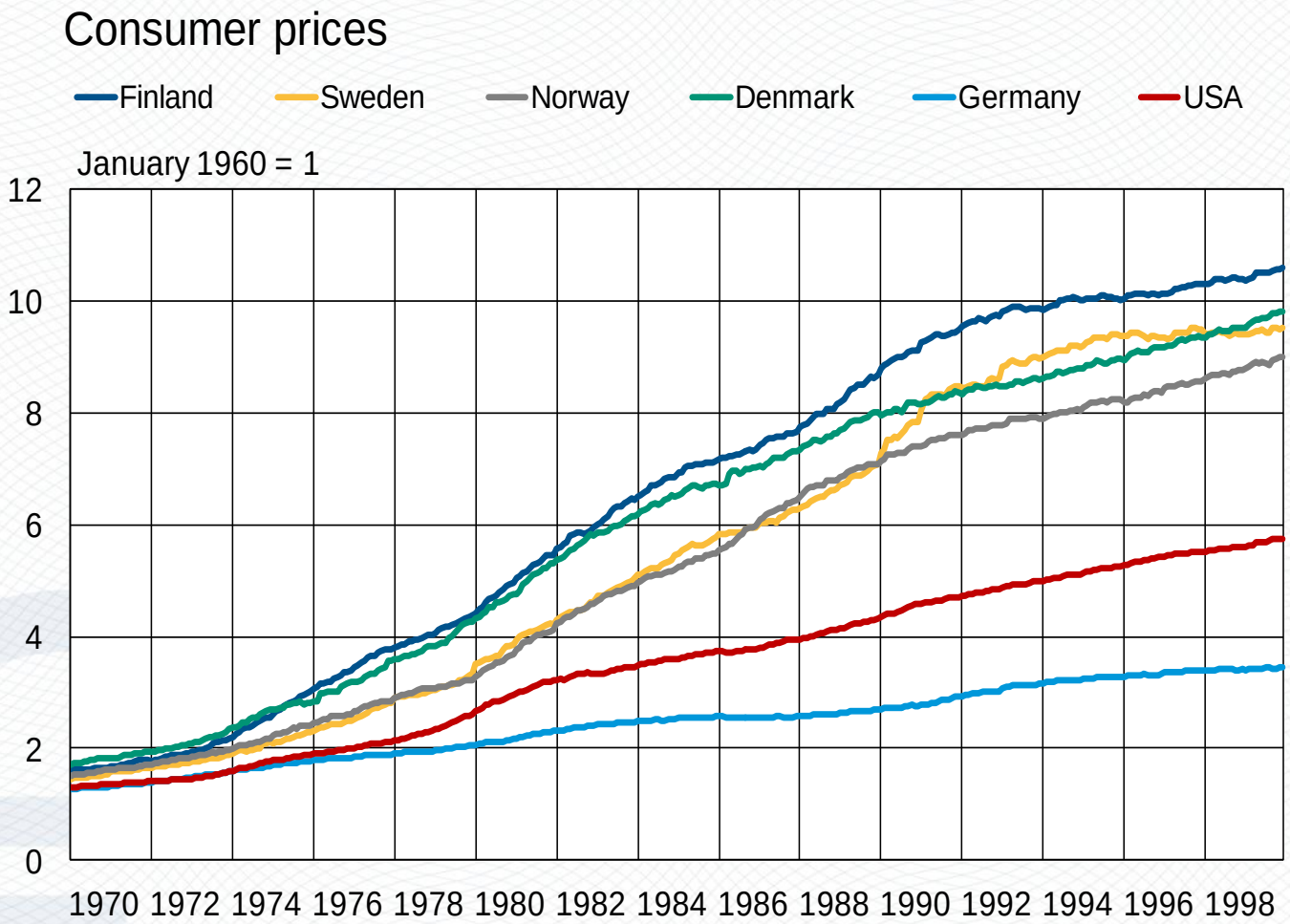

Source: OECD.

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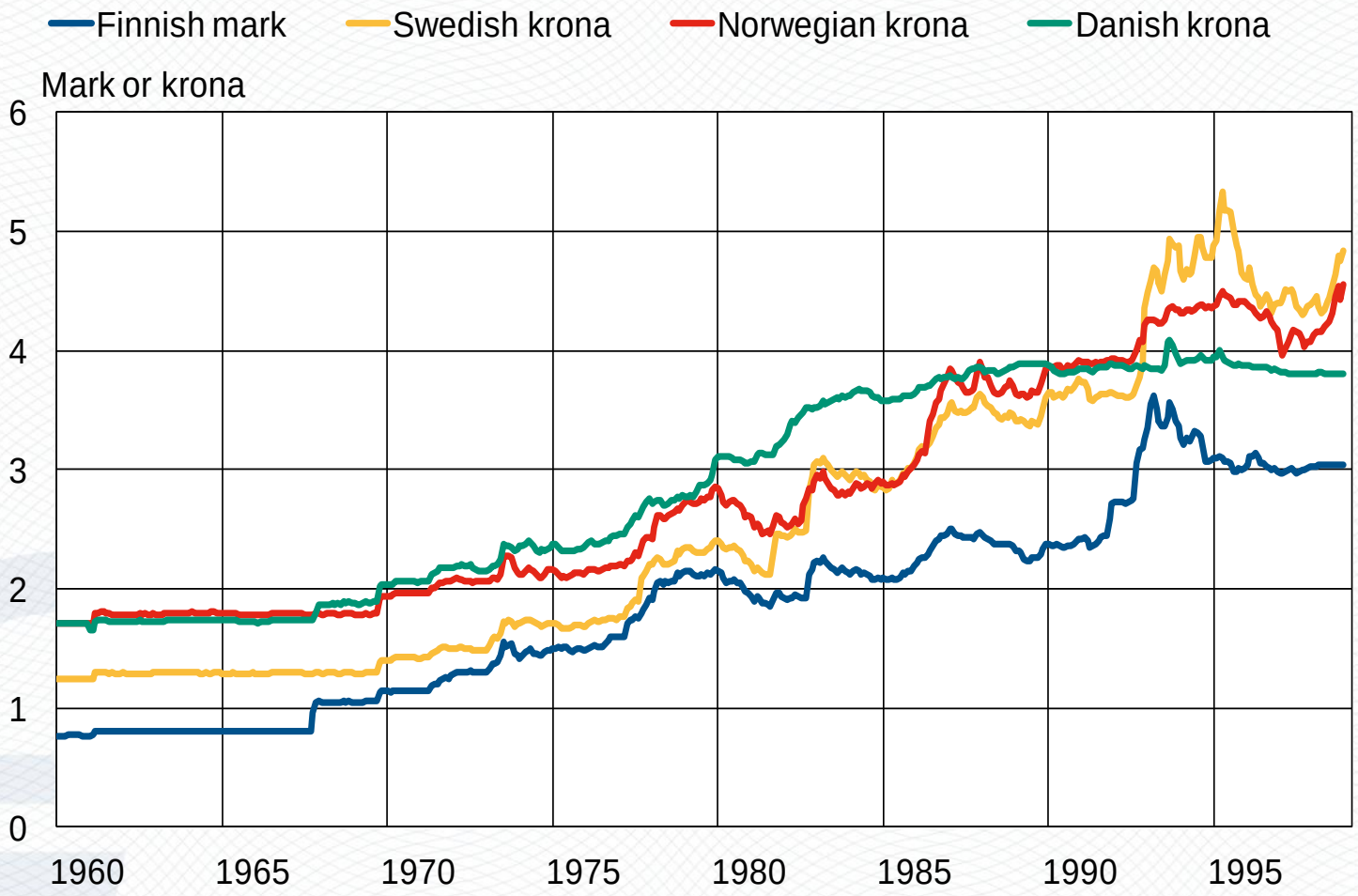
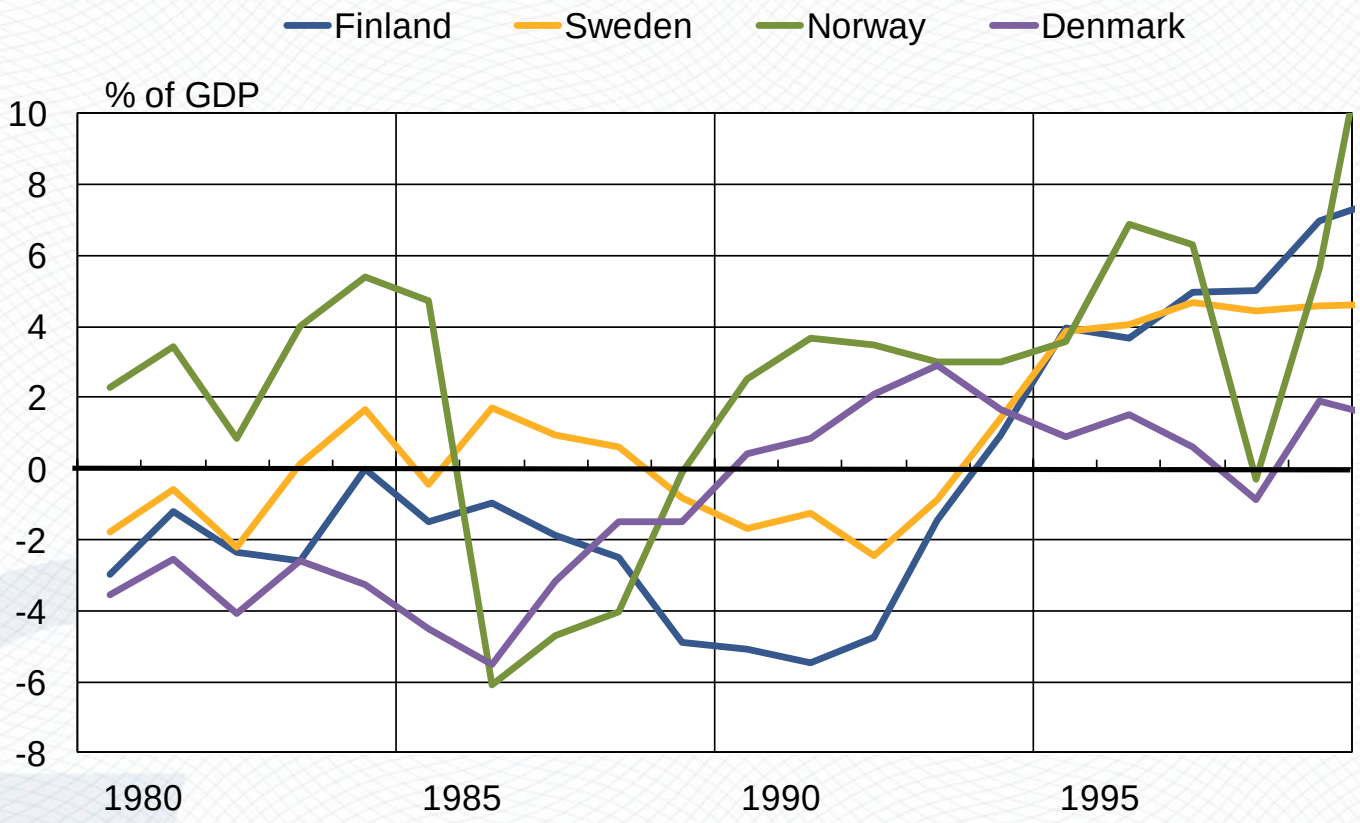
Nordic currencies against German mark



Source: Bank of Finland.

Current account



Source: European Commission.

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II.1 Nordic financial systems in early 1980's

- Denmark had a more liberal system.
  - Details will not be discussed.
- Financial systems were tightly controlled:
  - Interest rate controls by the Central bank.
  - Central Bank controlled credit flows in the economy.
- Banking system dominated by a few large banks and many smaller banks.
  - Mostly private ownership of banks,
    - capital largely raised from the private sector
  - Banks rationed credit to households and firms.

- Exchange rates pegged to currency baskets.
- Capital account controls:
  - Permits for long-term movements,
  - no short-term financial movements,
  - Foreign trade finance relatively free,
  - Foreign exchange for travel rationed.
- Non-bank systems:
  - Stock, bond markets and insurance sector kept small,
  - no major non-bank intermediaries (except special finance companies),
  - activities of foreign banks very restricted.
- Supervision focused at compliance in lending and accounting, no risk supervision.

- Competition restricted by regulation of interest rates, entry into financial market, etc.
  - Also new bank branches restricted.
  - Subsidiaries of foreign banks not allowed.
- Strong legal system (”Rule of law”)
  - e.g. bankruptcy procedures.
- Very stable banking systems:
  - Very low loan losses,
  - inefficiencies: large personnel and branch networks.
- Tight controls protected independent monetary policy.

II.2. Main aspects of Nordic deregulation

- Growth of international trade and internationalization of firms.
  - This created pressures to liberalize.
- Growth of international financial markets.
  - IMF, OECD, EU sought liberalizations of markets and capital flows.
- Leakages and loopholes in the controls emerged.
  - ”grey” domestic financial intermediation in late 1970’s and 1980’s.
- Liberalization involved numerous individual acts
  - see slide for Finland.
  - Volatility in macroeconomic developments from the liberalization.

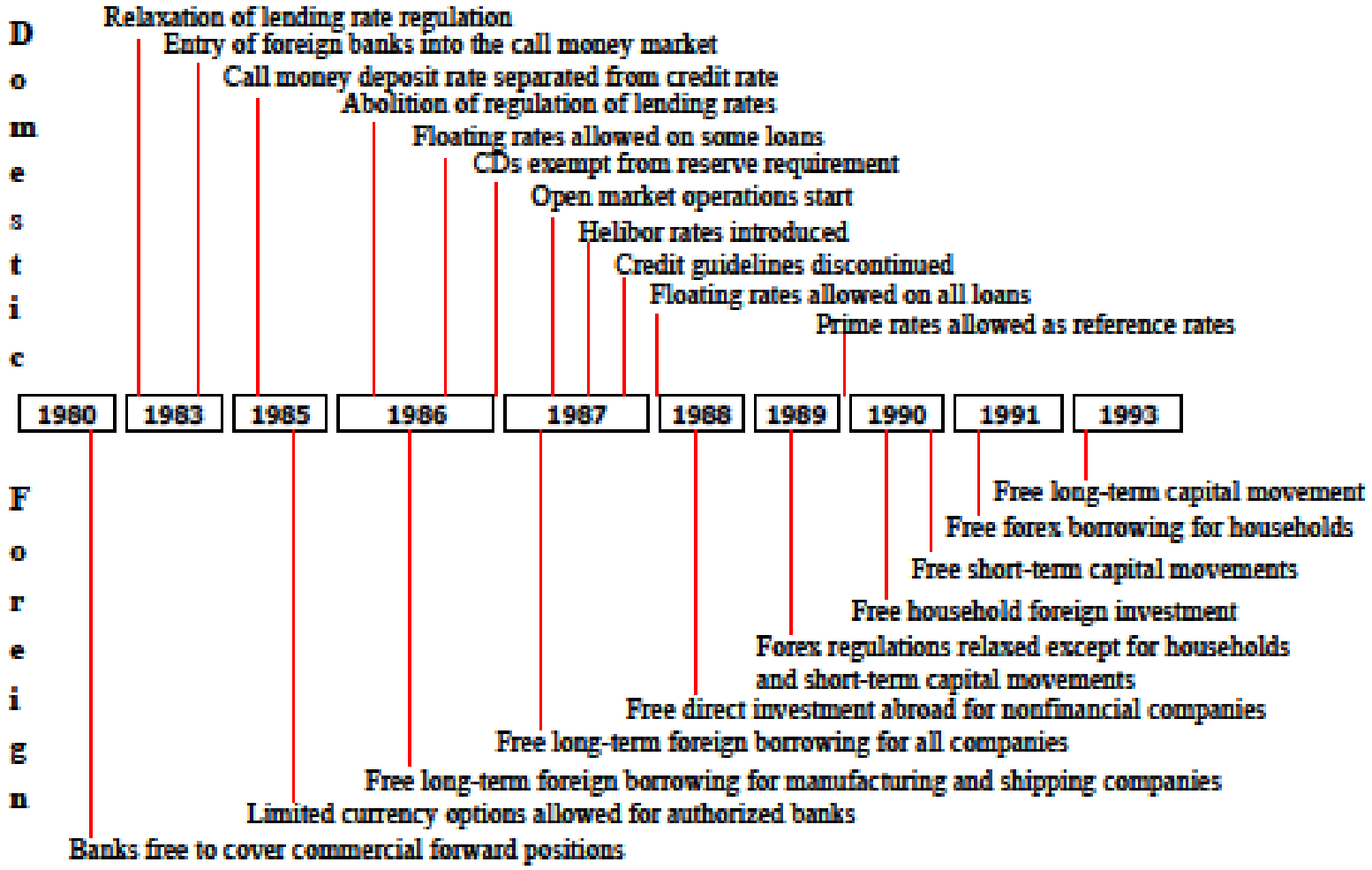


Chart 3B. Deregulation of financial markets in Finland

Source: Englund & Vihriälä (2003)

III. Central issues in financial deregulation

- Liberalization of financial and foreign exchange markets limits the leeway of domestic economic policy.
- **Impossible trinity:** with free markets one cannot fix exhange rate, domestic interest rate and quantity of finance.
- Order of liberalization:
  - Domestic market before international capital movements or vice versa?
  - Which order for different markets in terms of maturity, sector finance, derivatives etc.

- Other issues:
  - Which order for currency denomination (domestic vs. foreign)?
  - Which order for exports and imports of capital?
  - Should there be response to market pressure?
  - When might deregulation steps be reversed?

- Nordic countries liberalized domestic and currency markets and capital movements in tandem.

- Decisions about taxation of finance:
  - Is debt finance favored?

III.1 Problems in Nordic liberalizations

- Bad timing, espec. for Sweden and Finland
  - big steps were taken in 1985-86, when business cycle suddenly turned upward.
  - Collapse of OPEC cartel -> lower oil prices. (Norway)
- A boom developed in Sweden and Finland.
  - It turned into a systemic banking, currency and economic crisis at the start of 1990's.
    - Collapse of Soviet Union was a big shock for Finnish exports.
    - Norway experienced only a banking crisis.
    - Denmark had banking problems but no systemic crisis.
- Other problems:
  - Narrow focus on executing the acts of liberalization was insufficient.
  - There was little aid to markets, firms, households and banks in adjustment toward competition with flexible prices.

- Problems continued:
  - Very little realization that liberalization to market-based finance implied increased risks.
    - Risk management viewpoint became important for banks.
- No reform of financial regulation:
  - Not only compliance regulations,
  - risk assessments and systemic viewpoint were missing.
- Macroeconomics:
  - The fixed exchange rate systems came under pressure.
  - Nordics moved to floating of Forex rates in 1992 and adoption of inflation targeting.

III.2 Lessons

- Dangers from lack of financial knowledge
  - Traditional way of thinking becomes a trap.
  - This reform is much more than technical adjustments.

♦ A cautious and gradual approach is probably better than a ’big bang’.

♦ Important to time well acts of liberalization:
  - To avoid pro-cyclicality.
  - Strengthen capital ratios of banks well before.
  - Reform the supervisory system in advance.

- Macroeconomic aspects:
  - Reforms for the taxation system.
  - Make exchange rate flexible before opening capital movements.

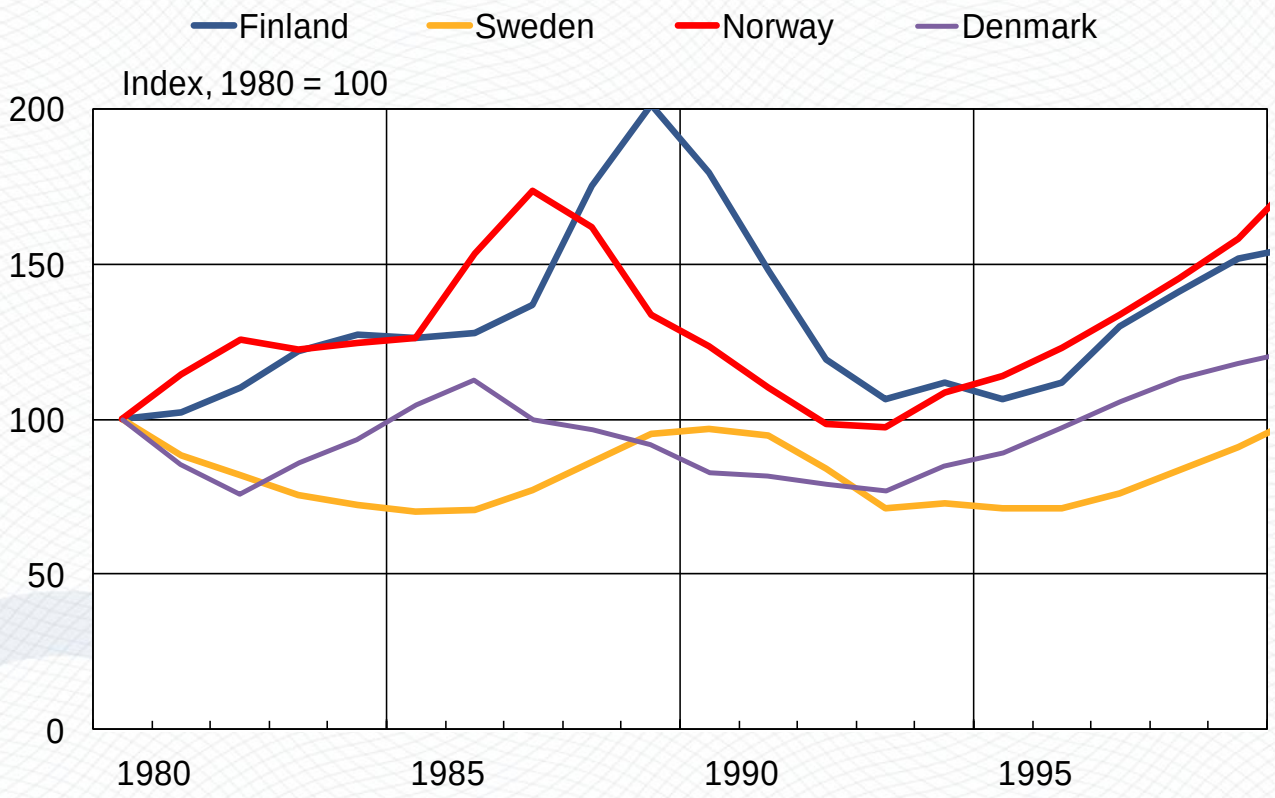
- Liberalization has long-run benefits for growth and development.
  - But there are limits. A fully laissez faire financial system is likely to be unstable.

- In case a financial crisis emerges:
  - Take swift action to maintain stability and confidence of the banking system.
  - Contain moral hazard when dealing with banking crisis.

IV. Managing the Nordic financial crises

- At the start of 1990's the boom turned into systemic banking, currency and economic crisis.
  - Denmark had banking problems but no systemic crisis.
  - Norway experienced only a banking crisis.
  - Finalnd experienced a big shock in exports which deepened the crisis.
- Financial crises (see slides):
  - Big declines in real estate and share prices.
  - Bank lending turned negative after rapid growth.
  - Loan losses and negative operating profits for banks

Real house prices



Nominal house prices deflated using the consumer price index.
Sources: Statistics Finland, Statistics Sweden, Norges Bank, Statistics Norway and Bank of Finland.

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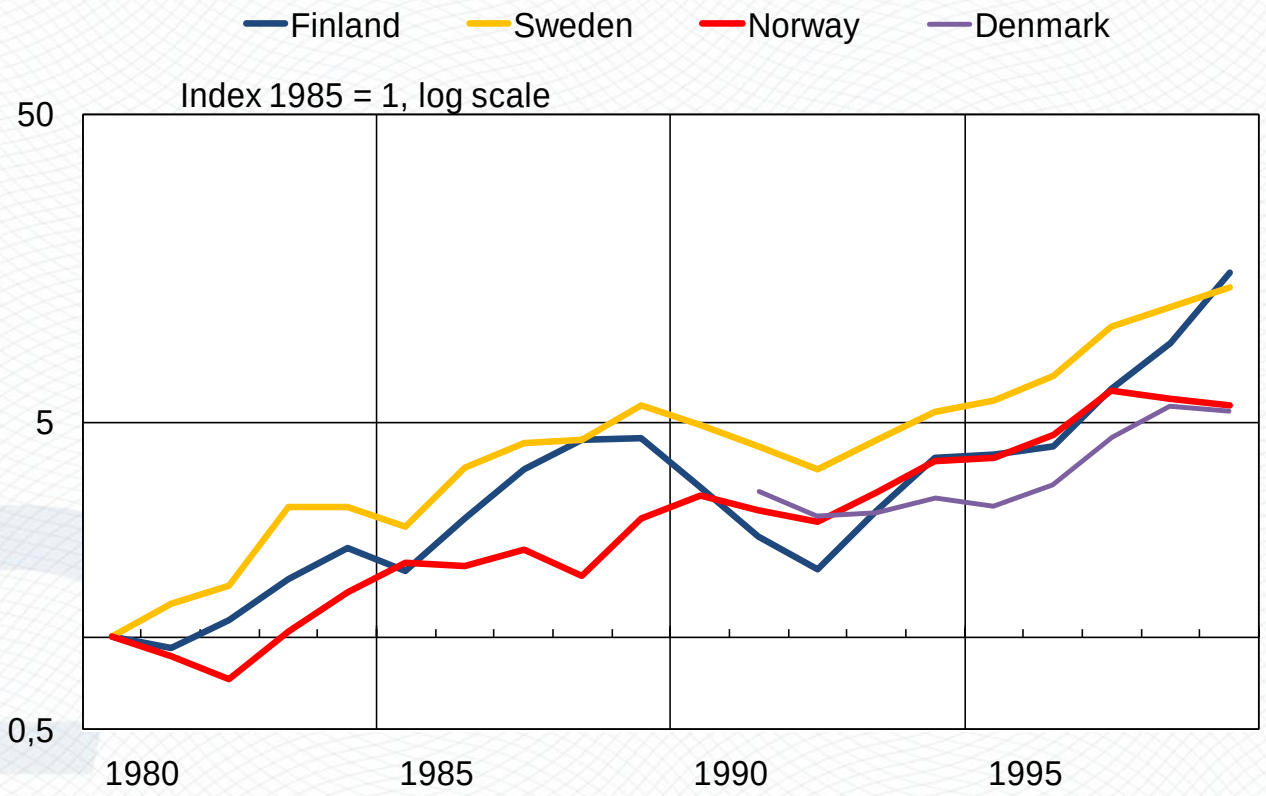
Real share prices



Nominal share prices deflated using the consumer price index.
Sources: IMF, ECB and Bank of Finland.
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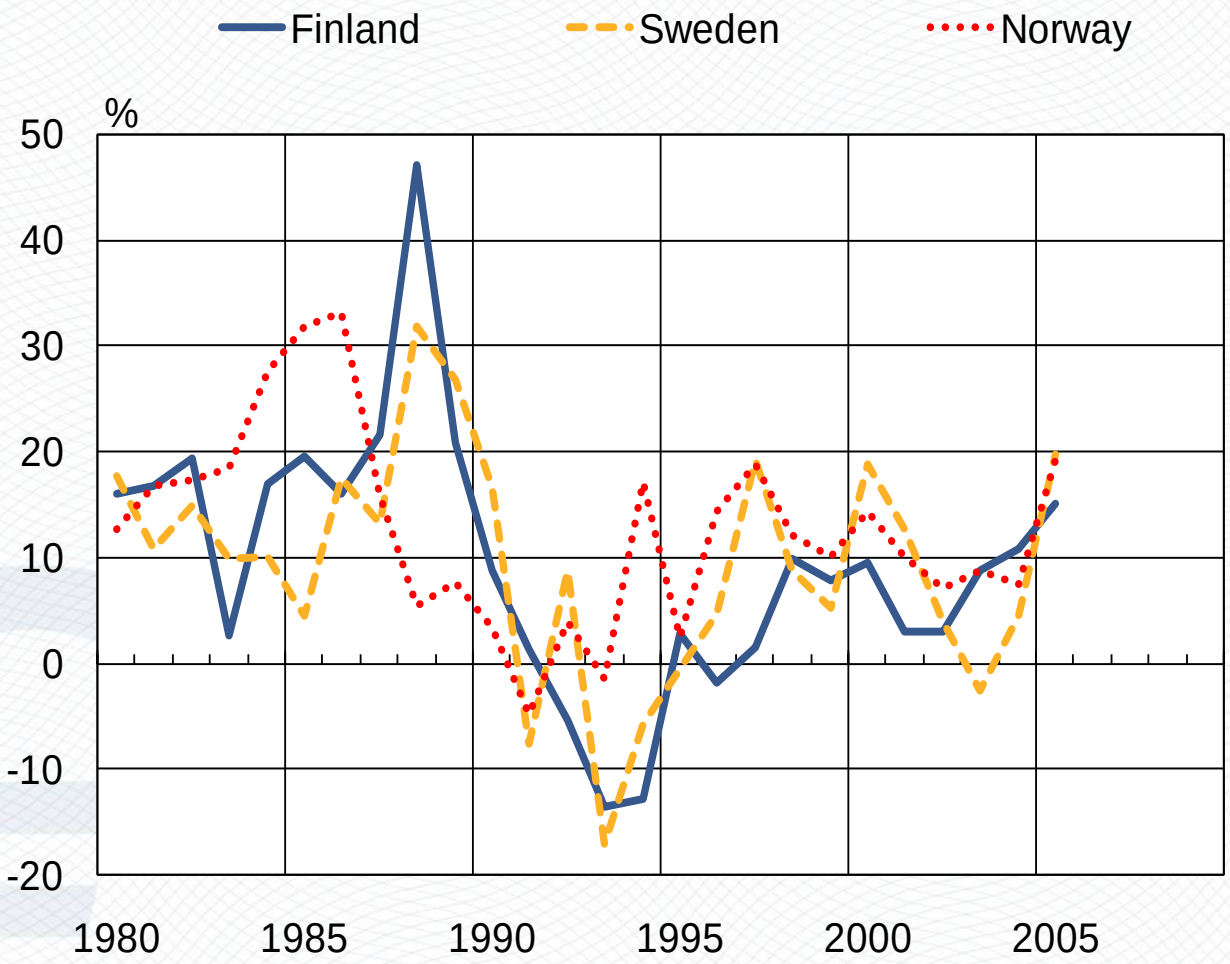
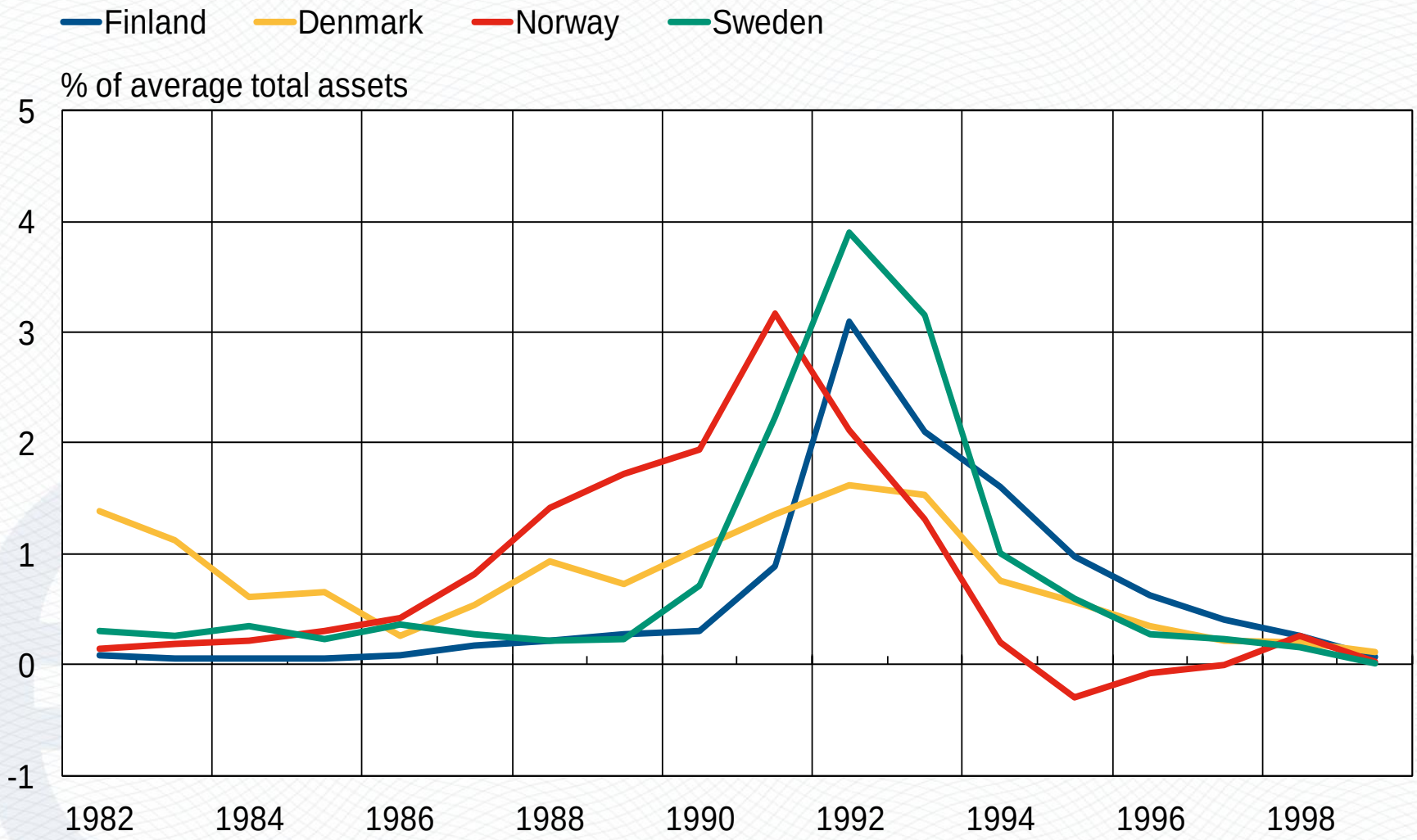
Figure 6. Lending growth



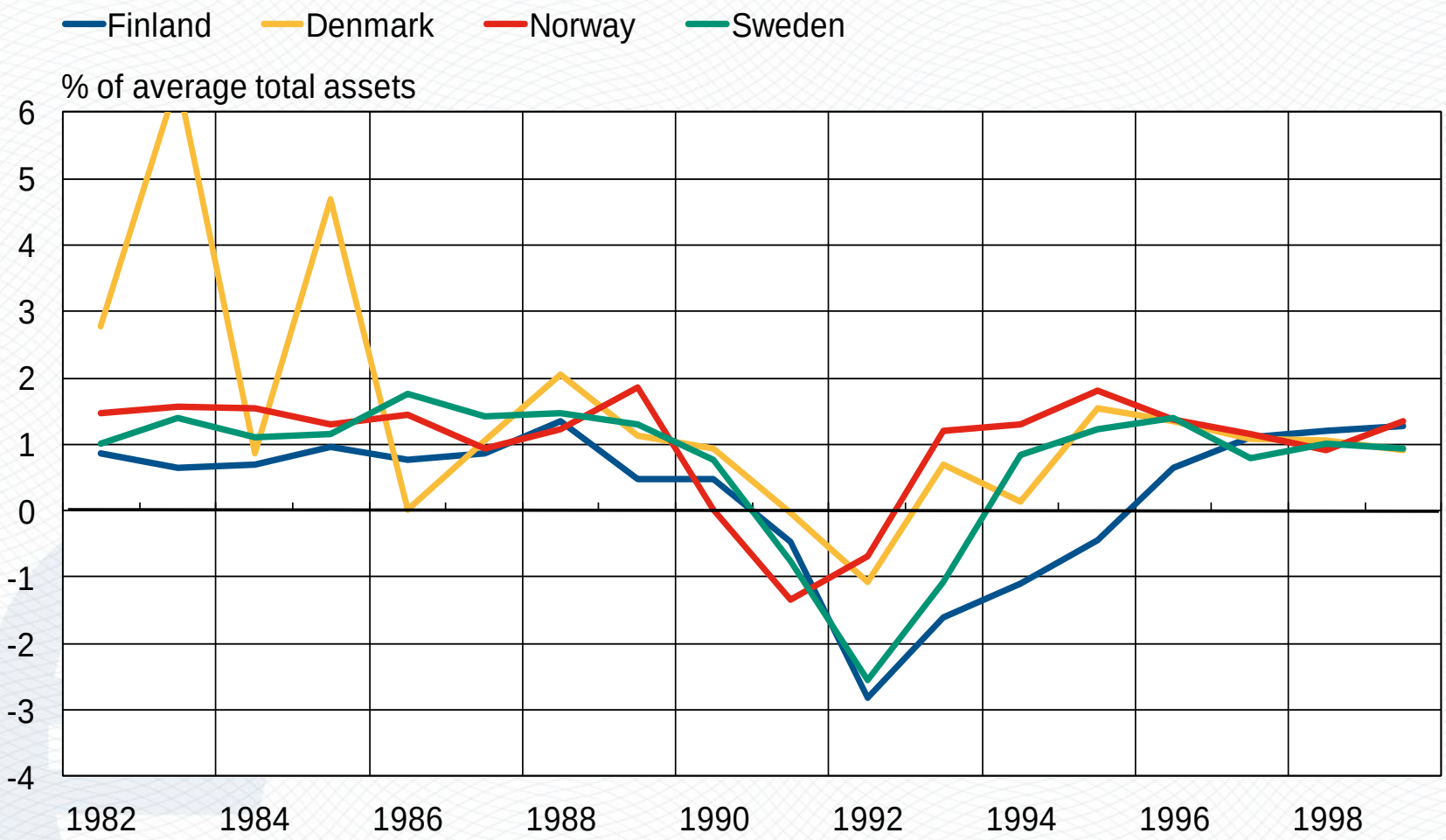
Sources: OECD and Bank of Finland.

Nordic banks' loan losses



Source: National central banks.

Nordic banks' operating profits



Source: National central banks.

IV.1 Crisis management

- **Finland**
  - 1st measure: Bank of Finland took control of Skopbank in September 1991.
  - Government set up the crisis management agency.
  - Public support: preferred capital certificates to banks, with strict requirements.
  - Policy-makers made promises to guarantee banks' obligations, also further public support.
  - Support to be converted into shares if not repaid.

- Finland (continued)
  - Banks became profitable again in 1996
  - Improved efficiency (staff was halved, etc.)
  - Major restructuring of banking system:
    - savings banks largely disappeared,
    - one big commercial bank was merged to another.
  - Nowadays 60 percent of banks owned by foreigners

=> Biggest part of the crisis was in the Savings Banks system.

- **Sweden**
  - Crisis erupted in autumn 1991 with Första Sparbanken; government gave a loan and FS merged with other savings banks.
  - Nordbanken (3rd largest comm. bank) was 71% govt owned and had to be recapitalized.
  - Many banks made heavy credit losses.
  - In autumn 1992 blanket creditor guarantee by government.
  - Crisis resolution agency set up, public support with strict criteria in risk reduction and efficiency.

- Sweden (continued)
  - Some banks did not need public support.

  ⇒ In the end nearly all support went into two banks, Gotabanken and Nordeabank.

    - Nordeabank became a pan-Nordic bank ”Nordea”.

- **Norway**
  - Crisis erupted in autumn 1988.
  - Initially private guarantee funds provided support and bank mergers took place.
  - In late 1990 private funds were exhausted, so government guarantee funds set up in early 1991.
  - Support had to be converted into solvency support.
  - In autumn 1991 capital support needed.
  - In Spring 1992 several banks, incl. three biggest commercial banks were nationalized

- Norway (continued):
  - no blanket guarantee by government, but specific announcements about securing depositors and creditors.
  - Banks situation started to improved in 1993.
  - One of nationalized banks was sold in 1995 and two other banks were sold later.
  - Government still owns over 30 percent of one bank.

=> In the end the Norwegian tax payer made money out of the crisis (not so in Finland and Sweden).

	Gross cost	Net cost
Finland	9.0 (% of 1997 GDP)	5.3 (% of 1997 GDP)
Norway	2.0 (% of 1997 GDP), 3.4 (present value , % of 2001 GDP)	-0.4 (present value, % of 2001 GDP)
Sweden	3.6 (% of 1997 GDP)	0.2 (% of 1997 GDP)

IV.2 Lessons

- **Prevention of major crisis** is the first priority.
  - stability-oriented macro policies
- How to diagnose an overheating situation?
  - rapid credit expansion
  - strong increase in leverage
  - big external deficits in open economies
- Political-economy reasons can be a major obstacle in crisis prevention.

- Crisis management:
  - Maintaining confidence in banking system is crucial.
  - Broad political support; political guarantees to banks' obligations in Finland and Sweden but not in Norway.
- Role of central banks:
  - Liquidity support in Norway and Sweden.
  - Bank of Finland had to take over a problem bank.

- Crisis resolution agencies in all three countries
  - Administrative separation from central bank and ministry of finance,
  - capital injections to banks,
  - guiding the restructuring of the banking system,
  - Treatment of ”old shareholders” was mixed.
- Asset management companies (”bad banks”) to deal with non-performing assets
  - Norway: banks had their own bad banks,
  - Finland and Sweden had public agencies.

=> Nordic practices in crisis resolution have been praised afterwards.

Thank you !

For more detailed discussion see:

- Honkapohja, S., 2014. Lessons from the Financial Liberalization in the Nordic Countries in the 1980s, in Woo, W.T., Pan, Y. , Sachs, J., Qian, J. (Eds.), *Financial Systems at the Crossroads*, World Scientific Publishing, Singapore, pp.135-163.

- Honkapohja, S. 2014. Financial Crises: Lessons from the Nordic Experience, *Journal of Financial Stability*, forthcoming.