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

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Outline

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   - Financial deregulation, main aspects
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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.
• Maastricht Treaty in 1992 made free movement of capital a cornerstones of EU.
  – 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

1985 = 100

Source: Eurostat.

26487
Consumer prices

January 1960 = 1

Source: OECD.
Nordic currencies against German mark

- Finnish mark
- Swedish krona
- Norwegian krona
- Danish krona

Source: Bank of Finland.
Current account

% of GDP


Finland Sweden Norway Denmark

Source: European Commission.

25125@Chart2_2 (en)
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 exchange 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.
  – Finland 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.
Real share prices

Index 1985 = 1, log scale

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

25125@Chart5 (en)
Figure 6. Lending growth

Sources: OECD and Bank of Finland.
Nordic banks' loan losses

% of average total assets

Source: National central banks.
Nordic banks' operating profits

% of average total assets

Finland Denmark Norway Sweden

Source: National central banks.
IV.1 Crisis management

• Finland
  – 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
  – 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).
<table>
<thead>
<tr>
<th>Country</th>
<th>Gross cost</th>
<th>Net cost</th>
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<tbody>
<tr>
<td>Finland</td>
<td>9.0 (% of 1997 GDP)</td>
<td>5.3 (% of 1997 GDP)</td>
</tr>
<tr>
<td>Norway</td>
<td>2.0 (% of 1997 GDP), 3.4 (present value, % of 2001 GDP)</td>
<td>-0.4 (present value, % of 2001 GDP)</td>
</tr>
<tr>
<td>Sweden</td>
<td>3.6 (% of 1997 GDP)</td>
<td>0.2 (% of 1997 GDP)</td>
</tr>
</tbody>
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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:
