1. Introduction

Lars Jonung, Jaakko Kiander and Pentti Vartia

‘It’ – that is, a deep depression – cannot happen here. This was the general attitude among economists, policy-makers and the public in Finland and Sweden prior to the early 1990s. Why should a depression take place in an advanced Nordic welfare state with a long tradition of full employment policies and strong labour union influence on the design of economic and social policies? Indeed, the macroeconomic record of Finland and Sweden during the post-World War II period was characterized by stable growth and low unemployment. Moreover, these two countries and their Nordic neighbours, Norway and Denmark, seemed to be able to combine an egalitarian society with strong economic performance.

But ‘it’ happened – to the great surprise of many.¹ The picture of the successful Nordic economies was shattered at the beginning of the 1990s when Finland and Sweden faced a severe crisis, falling real income, soaring unemployment and exploding public deficits. Previously, few understood that the macroeconomic policy regimes and thus the macroeconomic stability that had evolved in Finland and Sweden after World War II rested on far-reaching external and internal financial regulations. The system of capital account (foreign exchange) controls isolated the two countries financially from the rest of the world, in this way allowing domestic credit market regulations, setting interest rates and determining the allocation of capital according to political priorities.

In the early 1980s, the financial systems of the two countries underwent major deregulation. In several steps the Nordic economies became financially integrated with world capital markets. This process gave the impulse to a boom–bust cycle with devastating consequences. Finland and Sweden went into the deepest depression of the post-World War II period in the early 1990s.

The contributions in this volume examine the macroeconomic and financial developments in Finland and Sweden before, during and after the deep crisis of the 1990s, and compare them across time and across countries. The unique feature of this book is the comparative approach adopted. Chapters 2–5, the first part of the volume, focus on Finland and Sweden. Chapters 6–9, which form the second part, bring in an
international perspective. Here the record of boom–bust cycles and financial crises of other countries is considered and contrasted with the case of Finland and Sweden. Finally, Chapter 10 condenses the lessons from the Nordic crises of the 1990s. Chapters 2–10 are summarized below to give an overview of the contents of the volume.

1.1 PART I: THE CRISIS OF THE 1990S IN FINLAND AND SWEDEN

In Chapter 2, ‘The great financial crisis in Finland and Sweden: the dynamics of boom, bust and recovery 1985–2000’, Lars Jonung, Jaakko Kiander and Pentti Vartia explore the anatomy of the boom, the deep depression and the recovery in the Finnish and Swedish economies in the period 1985–2000. They divide these 15 years into three phases: the boom and the overheating of 1985–90, the outbreak and spread of the crisis to all sectors of the economy in 1990–92, and the recovery process 1993–2000. The comparative perspective of Chapter 2 reveals that Finland and Sweden followed a strikingly similar pattern of economic policies, macroeconomic performance and institutional changes. The two countries behaved as if they were ‘economic twins’.

The authors, inspired by the debt deflation theory of Irving Fisher, focus on the interaction between financial market developments and general economic activity in Finland and Sweden. When their story starts, the monetary policy of both countries rests on a pegged (fixed) exchange rate. This ‘initial condition’ turns out to be a crucial feature in the drama that follows.

For the boom phase, Jonung, Kiander and Vartia demonstrate how financial deregulation started off a process of credit expansion, asset price inflation, rapid growth in consumption and investment, an inflow of foreign capital, loss of foreign competitiveness, and speculation against the pegged exchange rates in both countries. For the bust phase, they describe a vicious circle of rising real rates of interest, falling asset prices (asset price deflation), financial fragility, exploding budget deficits and rising unemployment. Finally, the process came to an end when the central banks were forced to abandon the pegged exchange rate regime and allow the markka and krona to float in the fall of 1992. The authors stress the role of monetary and fiscal policies first in creating and then in alleviating the crisis. Finally, they examine the recovery phase.

How could the Finnish and Swedish economies end up in such deep and long-lasting stagnation? Why did policy-makers allow this to occur? Jonung, Kiander and Vartia answer by identifying the forces, domestic
and international, behind the exceptional depth of the crisis in the two countries. In short, policy-makers did not understand the forces that they set in motion by financial deregulation. There was a lack of accurate forecasts and analyses of the effects of financial liberalization. Attempts by governments to reduce budget deficits through tax increases and expenditure cuts reduced private demand and made the crisis still deeper. The deregulation was in itself a desirable and long-delayed step to reform the Finnish and Swedish economies. However, in order to avoid starting a boom–bust cycle, it should have been carried out in combination with measures that counteracted the credit boom that emerged.

The lack of financial knowledge leading to disastrous policy mistakes is fairly easy to explain. Pre-crisis thinking in Finland and Sweden on macroeconomic issues was strongly dominated by the experience from the post-war growth period and by the Keynesian approach with its stress on flow concepts and neglect of financial variables. The fact that the role of portfolio imbalances was disregarded was largely due to the system of strong regulation of the financial system in Finland and Sweden in place during the post-World War II period up to the financial deregulation in the late 1980s. As financial markets were held dormant, knowledge of the effects of financial forces became meagre.

A new economic order emerged in both countries after the depression of the early 1990s based on the free flow of capital across borders, stronger central bank independence, and convergence to the EU institutional framework. Both countries adopted an inflation target for monetary policy shortly after their currencies were floated. In January 1999 Finland joined the euro area. Sweden has chosen to remain outside with an inflation-targeting central bank. The inflation rate has been kept at low levels in both Finland and Sweden, significantly lower than the rates of the 1970s and 1980s. It remains to be seen whether Finland and Sweden – after Sweden’s decision in September 2003 to remain outside the euro area – will evolve along significantly different macroeconomic paths. Will the two economically identical twins now separate, after following the same stabilization policy road throughout the post-war period? Jonung, Kiander and Vartia leave this question to the future to be answered.

In Chapter 3, ‘Financial crisis in Finland and Sweden: similar but not quite the same’, Peter Englund and Vesa Vihriälä focus on the financial and banking aspects of the crisis of the 1990s. They trace in detail the process of deregulation of banking and financial markets that occurred in both countries in the 1980s. As a result of financial liberalization, instead of being forced to invest in government and housing bonds, banks became free to lend where return prospects were best. They were no longer affected by lending guidelines. For the first time in decades, banks and other
financial institutions, like any retail business, were able to compete freely for borrowers. The financial deregulation took place in economies with a suppressed demand for credit, largely due to the combination of high inflation and low or negative real after-tax interest rates.

As expected, the deregulation triggered lending booms in both countries. But it was not the lending booms *per se* that led to the subsequent crises, according to Englund and Vihrälä. Rather, the crises were due to the combination of several extraordinary shocks and serious policy mistakes, both concerning macro policies and regulatory policies.

The years around 1990 were unusually turbulent with a series of negative international macro shocks. First, the increase in European interest rates had particularly negative effects in countries with high government debt, like Sweden. Second, external demand declined in response to the higher interest rates and the crisis in the Persian Gulf. Third, the ERM crisis set off turmoil in exchange markets with a strong impact on small countries like Finland and Sweden, trying to defend pegged exchange parities increasingly removed from their fundamental values. Finally, the collapse of the Soviet export market hit Finland.

The pegged exchange rate regime followed by both countries was a crucial factor in the crisis scenario. When financial liberalization unleashed suppressed demand and stimulated growth, attempts to tighten monetary policy were largely futile. The exceptionally strong political commitment to the pegged exchange rate failed to maintain confidence in the exchange rate regime. When the financial positions turned more vulnerable, attacks on the peg of the *markka* and the *krona* became more frequent.

In the end, the pegged exchange rate regime had to be abandoned. The Finnish devaluation in 1991 helped export recovery to start earlier. But the decision to devalue rather than float left the pegged exchange rate still subject to speculation, thereby contributing to high interest rates. This, combined with windfall losses from loans denominated in foreign currencies, weakened the financial position of the domestic sector in Finland. From the point of view of the domestic sector, including the banking sector, the Finnish approach to floating was less successful than the Swedish one, with just a brief period of very high interest rates before floating in November 1992. Obviously, both countries would have benefited from an earlier floating, according to Englund and Vihrälä.

The recession that started in both countries around 1990 hit a banking system with low solidity, high-risk loan portfolios and highly leveraged borrowers. This triggered dynamic responses that banks and regulators were unaccustomed to. The interaction between falling asset prices, declining collateral values and rising credit losses was a phenomenon that hardly any of the actors had previously experienced. The crisis in the
financial system became deep. Englund and Vihriälä stress that crisis management and resolution policies were fast and strong-handed in Finland and Sweden. The financial sectors were substantially restructured. They recovered from the crisis relatively quickly. After the crisis, they emerged as highly efficient.

In Chapter 4, ‘The crisis of the 1990s and unemployment in Finland and Sweden’, Klas Fregert and Jaakko Pehkonen investigate the character, causes and aftermath of the huge unemployment of the 1990s in Finland and Sweden. They ask whether the current high unemployment is a legacy of the crises of the 1990s. Any attempt to evaluate the cost of the crises must take into account this possibility.

The crises in Finland and Sweden are alike in their initial timing, both starting in 1991 and ending in 1994. Finland’s crisis was deeper in both absolute and relative terms on all the unemployment measures they use. The non-employment rate, which takes into account both changes in the open unemployment rate and the outflow from the labour force, gives an upper limit of the increase in total unemployment. It rose in Sweden by 10 percentage points whereas in Finland it increased by 15 percentage points. By this measure, the Finnish crisis was 50 per cent worse than the Swedish one. A likely explanation is the corresponding steep decrease in job creation in Finland, which did not occur in Sweden.

Sweden had a quick recovery until 1994–95, after which unemployment remained constant until 1998, whereas Finland was in a recovery process for the rest of the 1990s. After 1998, when unemployment began to decrease in Sweden, the two countries also differ in that the inflow into unemployment and the duration of the average spell of unemployment continued to decrease in Finland, whereas the recovery from 1998 in Sweden was due solely to a sharp decrease in duration. One legacy of the crisis shows up in the share of temporary employment, which rose substantially in both countries in the 1990s.

The authors estimate Okun and Beveridge relations with structural breaks, which imply that the structural unemployment rate doubled in both countries in the early 1990s. These findings corroborate those of previous studies, which suggest, on average, a rise of about 4–6 percentage points for Finland and 2–4 percentage points for Sweden in structural unemployment. The authors also attempt to measure the contributions of possible causes to the changes in the structural unemployment rate, by using previously estimated models. These are based on panels of OECD countries, which link unemployment to institutional factors and the business cycle.

Fregert and Pehkonen suggest that the rise in unemployment and its persistence at a high level was mainly due to a combination of aggregate
demand shocks and several small effects stemming from changes in institutions, aggravated by lagged adjustment. Since there is no one major factor that could be singled out, Finland and Sweden are prime candidates for the hypothesis that a negative demand shock together with rigid institutions leads to long-lasting effects.

The estimates by Fregert and Pehkonen demonstrate that structural unemployment remained constant in both Finland and Sweden over the late 1990s. For the early 2000s, the evidence suggests a modest decrease in structural unemployment, mainly due to lower rates of taxation, a lower replacement rate in the pension schemes and lower union density in both countries. Thus, most of the decline in open unemployment in the late 1990s and early 2000s was due to positive demand shocks. The authors stress that these findings should be treated as preliminary since they doubt the ability of existing models to fully explain the observed decrease in unemployment in Finland and Sweden.

In Chapter 5, ‘How costly was the crisis of the 1990s in Finland and Sweden?’, Thomas Hagberg and Lars Jonung set the crisis of the 1990s in a historical perspective by comparing the cost of the crisis of the 1990s with the costs of other major depressions in Finland and Sweden. Their analysis is based on a crisis chronology for Finland and Sweden from which they calculate the cost of major crises since the 1870s.

Finland and Sweden were spared severe economic depressions in the post-World War II period prior to the 1990s. In order to find crises on the scale of the 1990s, Hagberg and Jonung have to go back to the inter-war years and the classical gold standard period before World War I. Their survey of the literature on crises identifies three crisis episodes for Finland and six for Sweden worthy of comparison with the disaster of the 1990s. In addition, the two countries were deeply affected by World Wars I and II – Finland more so than Sweden due to its direct involvement in the hostilities. For this reason they include the war periods in their estimates of the costs of depressions.

A crisis brings costs to many groups in society – to banks, to the public sector, to those who become unemployed, to holders of equity and so on. Hagberg and Jonung focus on the costs to society at large in terms of output, employment and industrial production foregone during the years of crisis. They cover these three time series in order to get a comprehensive picture.

Judging from their calculations, the crisis of the 1990s was very costly compared with all major crises since the 1870s. In Finland, the loss in real income in the 1990s was the largest of any peacetime crisis. In Sweden, only the depression of the 1930s caused a larger loss in real income. The loss of industrial output remained moderate in both countries compared.
with other major crises. Employment in the two countries, however, was hard hit during the 1990s. The cumulative employment loss is the greatest on record, considerably higher than during the depression of the 1930s.

The impacts of the oil crises of the 1970s (OPEC I) and early 1980s (OPEC II) were dissimilar. OPEC I stands out as a crisis in both countries, though deeper in Finland than in Sweden. OPEC II, on the other hand, did not create a crisis in Finland and caused only minor losses in Sweden. Policy-makers apparently learned from OPEC I how to handle OPEC II. The two world wars emerge as the most costly of all the depression episodes examined.

The numerical results in Chapter 5 demonstrate the severity of the crisis of the 1990s. It was unusually deep and prolonged. It occurred after a long period of peacetime prosperity and growth, so long that policy-makers and the public probably thought that a deep depression could not happen again. Closing their chapter, Hagberg and Jonung guess that one reason why the crisis of the 1990s turned out so costly was that it came as such a surprise.

1.2 PART II: THE INTERNATIONAL CONTEXT

In Chapter 6, ‘The boom and bust cycle in Finland and Sweden in an international perspective’, Lars Jonung, Ludger Schuknecht and Mika Tujula compare the boom–bust cycle in Finland and Sweden 1984–1995 with the average boom–bust pattern in industrialized countries as calculated from an international sample for the period 1970–2002. They start by adopting a technique to separate boom–bust episodes from standard business cycle phases for a large number of countries. In this way, they obtain a dating of boom–bust episodes to use when calculating the average behaviour of the variables they want to study in a comparative perspective.

Next, Jonung, Schuknecht and Tujula identify the driving forces behind the boom–bust pattern in Finland and Sweden, starting from a brief summary of the cyclical experience of the two Nordic countries based on Chapters 2 and 3 in this volume. This account helps them to identify key variables, such as domestic credit, asset prices, real interest rates, exchange rates, the current account, real growth, output gaps, consumption, investment, exports, employment, real labour costs, fiscal balances and public debt, to be examined more closely in the cross-country comparisons.

Two clear conclusions emerge from their comparisons between the Finnish–Swedish boom–bust pattern and that of other OECD countries as displayed in a large number of figures. First, the Finnish–Swedish pattern is much more volatile than the average. The boom as well as the bust is
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bigger in the two Nordic countries. This holds for practically every time series compared. Second, the bust and the recovery in the two Nordic countries differ far more from the international average than the boom phase does. The bust is much deeper and the recovery comes earlier and is more rapid than in the other countries of the sample.

Jonung, Schuknecht and Tujula explain the more volatile character of the Finnish and Swedish boom–bust as being due to the design of economic policies in the 1980s and 1990s. The boom–bust cycle in Finland and Sweden 1984–95 was driven by financial liberalization and procyclical monetary and fiscal policies, causing large and unexpected swings in the real rate of interest transmitted via the financial sector into the real sector and then into the public finances. Several factors contributed to the highly procyclical policy, most prominently the defence of the pegged exchange rate. The authors conclude that the Finnish and Swedish crisis of the early 1990s should be viewed as part of a full-fledged boom–bust cycle.

In Chapter 7, ‘The boom and bust cycle in Norway’, Erling Steigum presents roughly – but not exactly – the same story of boom and bust for Norway as told in Chapters 2 and 3 for Finland and Sweden. In all three countries, the initial impulse originated from measures to deregulate the financial system while maintaining a pegged exchange rate. The financial deregulation set off a lending boom, partly financed by capital inflows, driving up asset prices, reducing savings and causing high inflation, low unemployment and loss of foreign competitiveness, eventually turning into a bust, a recession and a systemic currency and banking crisis. In the end, Norway, just like Finland and Sweden, was forced to abandon the pegged rate of the Norwegian krone.

Steigum describes first the initial conditions. Prevailing institutions and views of policy-makers in Norway were roughly the same as in Finland and Sweden in the early 1980s. The monetary regime was based on a pegged exchange rate. Economic policies were selective and interventionist, a tradition going back to the 1940s. The deregulation of the Norwegian credit market took place in 1984–85, after many decades with caps on interest rates, quantitative regulations on the lending of commercial banks, and credit rationing.

The financial liberalization triggered a strong lending boom in 1985–87, financed by huge capital inflows. Norwegian banks were not prepared for this change in the financial environment. During the lending boom, ‘bad banking’ behaviour was widespread, such as giving strong incentives to inexperienced and newly recruited staff to ‘sell’ new loans without giving appropriate considerations to the risk of future loan losses. Generous tax deduction rules for nominal interest payments kept the after-tax real rates of interest close to zero, creating powerful incentives for households and
firms to borrow and spend. The household saving rate turned negative for four years (1985–88). Real estate prices and stock prices increased rapidly. High growth of private consumption and investment generated a strong business cycle boom. In 1987, the rate of unemployment was only 1.5 per cent, triggering double-digit wage inflation.

The fall in the oil price in the winter of 1985–86 had strong and negative effects on the current account and on the government’s fiscal position. The new Labour government in 1986 carried out a devaluation of the krone by 10 per cent and a policy of fiscal tightening. The government told Norges Bank, the central bank of Norway, to use the interest rate instrument to bolster the credibility of the pegged exchange rate of the krone.

The boom ended abruptly with a surprisingly deep recession in 1988–89, followed by stagnation and low growth, disinflation and increasing unemployment during the period 1989–2003. The bust was fuelled by disinflation, less generous tax rules and rising German rates of interest. The relative price (to the consumer price index) of non-residential real estate in Oslo peaked as early as 1986, and then fell by 56 per cent from 1986 to 1992. During the same period, the average after-tax real interest rate increased from about 1 per cent to more than 7 per cent. During the bust, bank loan losses reached levels not seen since the inter-war period. Still, it was three years from the onset of the recession in 1988 before a systemic banking crisis hit Norway in 1991.

Steigum demonstrates that the boom–bust cycle in Norway was not as severe as it was in Finland and Sweden, where it occurred a few years after the Norwegian boom–bust. The Norwegian boom was also shorter, probably due to the oil price shock in 1986 hitting Norway as an oil exporter. In addition, the Norwegian crisis was not as deep. Speculative attacks against the pegged exchange rate were more pervasive in Finland and Sweden, where the currencies were clearly overvalued prior to the attacks. In Norway, a speculative attack took place in December 1992 after – and probably inspired by – those in Finland and Sweden in the fall. At that time, the government had already salvaged the banking industry. When Norges Bank let the krone float, it fell by only 4 per cent. Later it recovered. This initial fall was much smaller than the depreciation registered in Finland and Sweden.

Norwegian monetary policy was procyclical during both the boom and the subsequent stagnation period due to the pegged exchange rate policy, as was the case in Finland and Sweden. The fiscal policy tightening from 1986 on was crucial in curbing the boom. The government waited too long, however, before giving fiscal stimulus after the recession. The changes in the tax rules regarding tax deductions for interest payments had a procyclical effect.
The rapid rise in interest rates stemming from Germany after its reunification had devastating effects. At that time the Norwegian banking industry was weak due to many years of losses and low profitability. Although the bank losses as a percentage of outstanding loans in Norway were not as huge as those in Finland and Sweden, the Norwegian banking crisis was just as systemic and dramatic. In 1991–92, the government rescued the three largest commercial banks (Christiania Bank, Den norske Bank and Fokus Bank), as well as a number of savings banks and medium-sized commercial banks. At this stage, Norwegian banks, particularly commercial banks, were poorly capitalized compared with those in Finland and Sweden. The aggregate bank loan losses were similar in size in Denmark and Norway, but the Danish banks had a much stricter capital requirement at the outset. In Denmark, there were no major bank failures, let alone any systemic banking crisis.²

The Norwegian method of rescuing the banking system was different from the Finnish and Swedish approach applied shortly afterwards. In Norway, the government took over the ownership of the large commercial banks by writing down the equity capital of the former private owners to zero before injecting new capital. The Norwegian government did not set up a separate entity to manage and recover non-performing loans (a ‘bad bank’). Moreover, no blanket guarantee for banks’ liabilities was issued in Norway as it was in Sweden.

Steigum notes that Norway was a Nordic pioneer in the sense that the boom–bust cycle in Norway occurred a few years before the boom–bust in Finland and Sweden. It may seem surprising that Finland and Sweden, being close neighbours to Norway, did not learn any policy lessons from the Norwegian process as it unfolded. One reason is that events followed each other very closely in the three countries, so there was not much time for policy-learning. Another reason may be that, once the process of financial liberalization had started, it was too late to take action. The ride in the roller-coaster was already on its way towards financial disaster. In addition, the experience of Norway was probably viewed as exceptional due to Norway’s large reliance on revenues from its oil and gas sector.

In Chapter 8, ‘How did Denmark avoid a banking crisis?’, Claus Vastrup explains how Denmark became a Nordic exception by staying on a monetary regime based on a pegged exchange rate and not being pulled into a systemic currency and banking crisis like Finland, Norway and Sweden. According to him, a combination of microeconomic and macroeconomic developments contributed to Denmark being spared the Nordic boom–bust pattern, although substantial problems emerged in the Danish banking sector as well as in the Danish economy in the 1980s and early 1990s.
Financial liberalization was carried out at an earlier stage in Denmark than in the other Nordic countries, several years prior to the deregulation in Finland, Norway and Sweden. The Danish deregulation was undertaken in the midst of a recession, and thus had no major impact on the stability of the banking sector at the time of liberalization. However, the financial position of commercial banks in Denmark deteriorated in the late 1980s. The problems peaked in 1991–93 when the total losses and loss provisions reached more than 5 per cent of GDP. As Vastrup demonstrates, the Danish banking system was able to absorb these losses and loss provisions because Danish banks were well capitalized – better than the banks of the other Nordic countries. The Danish banking system benefited also from more stable macroeconomic conditions in Denmark at the end of the 1980s and in the early 1990s than in the other Nordic countries.

The Danish economy was in a precarious situation in the early 1980s. Unemployment was high, deficits on the current account were large, and both inflation and interest rates were on the rise. In addition, policymakers faced a credibility problem as the Danish currency had been devalued several times and public sector deficits were large. At this juncture, Denmark decided to adopt a stability-oriented approach based on a pegged exchange rate.

The new policy approach was eventually successful. The firm commitment to the pegged exchange rate removed the inflation and devaluation bias of the past. A tight fiscal policy gradually eliminated the deficit on the current account by 1990, turning it into a surplus of 3 per cent of GDP in 1993. However, in the long process of turning the current account around in the 1980s, Denmark’s competitive position did not improve and economic growth was low, although positive and stable. Unemployment increased steadily from 1987 and reached more than 9 per cent when the international economic conditions deteriorated in 1992–93.

Fiscal policy turned expansionary in 1993 and particularly in 1994, ending a period of distress in the banking sector. Due to the surplus on the current account, the pegged rate remained credible. Following gradual reforms of the labour market and cautious demand management in the second part of the 1990s, unemployment fell to a level below that of most other European countries.

The European currency crisis in 1992–93 and the short-term Danish deviation from the pegged exchange rate regime did not undermine the stability of either the Danish economy or its banking sector. Denmark avoided the devastating crisis that hit Finland, Norway and Sweden at this time. Instead, according to Vastrup, the most important macroeconomic threat to the stability of the banking system was the low rate of economic
growth and the deflation of property prices in the late 1980s and early 1990s.

The case of Denmark demonstrates that financial deregulation may be carried out without causing a major financial crisis, contrary to the experience of the other Nordic countries. Danish monetary and fiscal policy maintained macroeconomic stability, the process of liberalization followed a proper sequencing, and commercial banks were well capitalized.

In Chapter 9, ‘The Nordic and Asian crises: common causes, different outcomes’, Ari Kokko and Kenji Suzuki provide a comparison of the Nordic and Asian financial crises. Their main message is that the causes of the two crises were largely similar, but that the patterns of reform and recovery differed between the Nordic and the Asian case.

First, Kokko and Suzuki trace the causes of the crises to simultaneous increases in the demand for and supply of credit due to financial liberalization. Both regions experienced export booms and rising demand for credit during the 1980s. In the Swedish case, the export boom was triggered by a series of currency devaluations in the early 1980s. In large parts of Southeast Asia, there was a shift from import substitution to an export-oriented growth strategy supported by devaluations. The increase in credit demand, originating in the expanding export sectors, gradually spread to other parts of the economies, including consumer credit.

Normally, the increase in credit demand would have been dampened by rising interest rates, but this did not happen because of developments on the supply side. The domestic credit markets in both regions were deregulated, international capital flows were liberalized, and banks began to compete for customers and market shares. Thanks to the resulting increase in credit supply, real interest rates remained low, and asset prices began to increase. Very soon, other prices were also rising.

In countries with pegged exchange rates (like Finland, Sweden and Thailand), the high rate of domestic inflation soon led to a reduction in international competitiveness. The export boom was replaced by a current account deficit financed by foreign borrowing. This deficit – which reflected a low domestic savings rate and a credit boom – could be sustained as long as foreign lenders were willing to provide the necessary funding. The crisis broke out when they started doubting the sustainability of the deficits and the pegged exchange rate, and refused to roll over maturing loans.

Countries with floating exchange rates (like South Korea) experienced a similar process with an appreciation of the real exchange rate: high domestic interest rates initially attracted so much foreign capital that the current account deficit did not cause any depreciation of the Korean currency.

Once the crisis was under way, it spread rapidly through the economy. The stock market and property bubbles began to deflate. Banks and other
financial institutions were forced to reduce their lending, and a downturn in production and employment followed. The fall in asset prices, eventually coupled with a reduction in the inflow of foreign capital, led to banking and currency crises. In the Nordic countries, there was also a crisis in public finances: the reduction in employment activated automatic stabilizers that pushed up huge public budget deficits.

The recovery from the crisis was very rapid in Finland and Sweden. The weakest banks and financial institutions were liquidated. Public funds were used to transfer problem credits to special asset management corporations. Within only a few years, the banking system had recovered and was breaking even. Substantial structural changes were undertaken in the industrial sector. Even the public budget deficits were eliminated a few years later.

In most of East Asia, by contrast, it took much longer to resolve the crisis. Kokko and Suzuki argue that it was not until 2004–05 that East Asia shook off the crisis. They propose several reasons why crisis resolution in Finland and Sweden was more efficient. First, they assert that the crisis in East Asia was deeper than the Nordic crisis, and therefore harder to resolve. This was partly due to weak supervisory institutions and unclear accounting rules, which allowed enterprises and financial institutions to take on excessive risk, and partly the result of a development strategy that promoted risk-taking. The links between political and economic interests throughout Asia made managers, investors and lenders act as if the state guaranteed some of the business risks.

Second, the recovery in Finland and Sweden was facilitated by their accession to the European Union. On the one hand, the EU pressured them to reduce their public deficits to sustainable levels, which gave the governments an important argument in the domestic debate with various interest groups that demanded compensation for losses incurred during the crisis. On the other hand, membership of the EU promoted trade as well as an inflow of foreign direct investments, generating growth and employment.

Third, the Nordic countries benefited from a favourable phase in the international business cycle, with the emergence of the ‘new economy’. In Asia, the recovery process included both the downturn in the IT sector in 2000 and the aftermath of the terrorist attacks in the US in 2001.

Finally, Finland and Sweden displayed a higher degree of ‘organizational learning capacity’ in policy-making than most Asian countries, according to Kokko and Suzuki. As a result, decisions were made in extensive consultation with different groups in society, the resulting policies were transparent, and they were implemented with relatively little interference from interest groups. In large parts of Asia, by contrast, decision-making systems were hierarchical and compartmentalized, with fewer
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sources of information, fewer challenges to established interpretations of information, and more discretionary decision-making and interference from interest groups. Thus, on the basis of their comparison, Kokko and Suzuki suggest that the most remarkable feature of the Nordic crisis was the rapid recovery.

1.3 PART III: LESSONS FROM THE NORDIC CRISES

In Chapter 10, ‘Twelve lessons from the Nordic experience of financial liberalization’, Lars Jonung summarizes the main findings in the previous chapters of this volume with the aim of turning them into policy recommendations. Thus, he tries to identify common elements in the Nordic experience. They are easy to find as the boom–bust stories of Finland, Norway and Sweden are largely identical.

Before presenting his message, Jonung emphasizes that lesson-drawing is not an exact science; it is strongly influenced by subjective judgements. Given this caveat, he suggests 12 policy lessons from the Nordic experience, organized under three headings: first, how to liberalize without causing a boom–bust cycle; second, how to deal with a financial crisis; and, third, the long-run effects of financial integration.

Jonung stresses that several of his lessons are closely related and that some of them are more important than others. Most of them stem from one source: the lack of knowledge of the dynamics created by financial liberalization. According to him, financial ignorance among policy-makers, forecasters, bankers, economists and the public turned out to be the key to the Nordic boom–bust cycle.

Under the first heading of how to liberalize without creating a crisis, Jonung proposes eight lessons, most of them expressed as warnings against policy mistakes. In his first lesson, he makes a plea for knowledge about the forces unleashed by financial liberalization to become widespread. A thorough understanding of the workings of financial markets is crucial to make financial liberalization and financial integration successful.

His second lesson concerns the dangers of backward-looking policy learning. The Nordic policy-makers made themselves prisoners of the past by regarding the crisis of the 1990s as identical to the devaluation crises of the 1970s and 1980s. For this reason they decided to defend the pegged rate to avoid repeating the failed policy of devaluations, thus making the financial crisis of the 1990s deeper than it would otherwise have been.

The third lesson states that large, rapid and unexpected swings in the real rate should be avoided. A more gradual approach, smoothing movements in the after-tax real rate, should restrain or even prevent boom–bust
episodes from occurring during financial deregulation. The fourth and fifth lessons are warnings against the types of procyclical stabilization policies and procyclical sequencing of financial reforms that destabilized the Nordic economies in the 1980s and 1990s.

After these warnings, Jonung concludes that a systemic financial crisis of the Nordic type cannot be prevented by financial micro-based supervision, the effectiveness of which is limited. Next, he argues that financial repression should be avoided – a simple lesson but not always an easy one to follow. He has a positive message as well when pointing to the case of Denmark to demonstrate an important lesson: financial liberalization can be crisis-free if it is combined with proper countermeasures.

The second set of lessons from the Nordic experience covers the proper policy response to dampen the impact of a crisis, once it has broken out. The most important one concerns the benefits of rapid crisis management. Quick, transparent and determined government actions to maintain public confidence in the banking system reduce the impact of a financial crisis and allow for a rapid recovery of the financial system.

Jonung argues that the Nordic crisis reveals that the lender-of-last-resort function of central banks is inadequate to support ailing banks. The policy lesson is that in a solvency crisis the government, not the central bank, should serve as the supporter of last resort of failing financial institutions. Turning to the policy advice of the IMF during the Nordic crises, Jonung makes a case that the IMF failed to understand the economy-wide impact of the process of financial deregulation that started in the mid-1980s. The policy lesson for a country in a crisis is to rely on advice and guidance from many sources, not only from the IMF.

The third set of lessons concerns the long-run effects of financial integration on the design of stabilization policies, on efficiency and growth and on the distribution of income and wealth in the Nordic economies. Here financial liberalization contributed to major changes, some of which transformed the Nordics into fast-growing economies during the long recovery phase. The lesson is that once financial markets are internationally integrated, pressure emerges to adjust domestic regulations and institutions to international patterns. In Jonung’s opinion, these effects are far-reaching, although they have so far not been given the attention they deserve.

Are these 12 lessons applicable outside the Nordics? Jonung replies in the affirmative. He argues that the Nordic experience of financial liberalization has much in common with that of other countries opening their financial system to the rest of the world. As a common pattern exists across most crisis-hit countries, he concludes that the Nordic lessons are of a general, not specific, nature.

In his summary, which may also serve as a summary of this introductory
chapter, Jonung states that the Nordic record of financial integration and of the financial crises of the 1980s and 1990s adds to our understanding of the causes and consequences of financial crises. The financial opening-up of Finland, Norway and Sweden started a sequence of events that brought these economies into deep depression. At this stage, in retrospect, the Nordic crises generate policy recommendations of a general nature that deserve close attention.

NOTES

1. The 'it' metaphor for the Great Depression of the 1930s in the United States is found in Chapter 1 in Minsky (1982).
2. See Chapter 8 on the Danish record.

REFERENCE