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Deregulation of financial markets and the risk of financial crises: Lessons from Sweden for China and other emerging economies

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Abstract

During and after the Central Committee's Third Plenum in November 2013, China announced far-reaching reforms in the spheres of marketization and economic deregulation that included financial markets. While the speed of the rollout of China's planned reforms is still unknown, officials repeatedly reference the great opportunities for guiding China onto a healthier, more sustainable social and economic track. The risks of such ambitious marketization and deregulation plans need to be considered in the context of speed and sequencing of reforms of the financial sector.

We currently lack the skills for overcoming the famously low predictability of financial crises. The areas for skill improvement largely relate to market psychology (behavioral finance) and the understanding of history and macrofinancial aggregates. The much-undervalued discipline of behavioral finance has started to come into its own over the past 10 to 15 years, including the awarding of the 2013 Nobel Prize Robert in Economics to Robert Shiller for his efforts at understanding the psychology of financial markets. This year's Nobel Prize winner, Jean Tirole, also considers behavioral aspects in his work.

Sweden has had two serious banking crises in the past 30 years. The first – and most serious – crisis occurred in the early 1990s, while a smaller crisis took place at the end of the last decade. Both were foreseeable. The first crisis emerged as Swedish banking entered uncharted deregulation waters, a situation Chinese reformers will themselves inevitably confront. Swedish research findings with respect to sequencing, speed of reforms and behavioral finance apply nicely to the Chinese discussion.

The italicized discussion focuses on what the Swedish deregulation experience means for Chinese policy choices, but most of these observations are generally relevant for policymakers in emerging markets in Asia and elsewhere.

Keywords: financial deregulation, Asia, Sweden

JEL: E61, F32, G02, N15, N25, N30, O53, P30, P35

The Swedish examples

Most economists would agree that each financial crisis has its own specific characteristics. While this is true to a great extent, financial crises also tend to have common roots. Perhaps the most significant is the creation and bursting of credit bubbles. Other causes include serious macroeconomic imbalances such as persistent high deficits in the current account and/or government budgets. Financial crises sometimes emerge when economic reform policy and financial deregulation are insufficiently coordinated. This was partly the case in Sweden in the late 1980s and early 1990s.[1] Lessons from Sweden's experience in these years should be quite valuable to policymakers in emerging countries in Asia and elsewhere preparing to launch or intensify processes of financial marketization and deregulation.

Crisis 1: The great financial crisis of the early 1990s

Even if globalization of financial markets over the past two decades has led to considerable changes in most countries, economic history still offers relevant insights. As we have seen since 2007, globalization of financial markets, if anything, means that countries with imbalanced markets or economies today are likely to get hit even *harder* than Sweden did during Crisis 1 in the early 1990s.

When looking at Sweden of the 1970s and 1980s, it is clear that there were only a few years when current account balances were roughly in equilibrium. There were several devaluations in the late 1970s and 1980s.

Besides its persistent inflationary problems, the overvalued Swedish krona plunged after the shift to a floating exchange rate system in November 1992. This was the outcome of fixing the krona unilaterally to the Deutschmark (mostly vis-à-vis a trade-weighted currency index) for most of the 1970s and 1980s. The artificial EU-currency unit, the ECU, succeeded the Deutschmark as the key fixing currency between June 1991 and November 1992. These were crucially negative links in times of mostly poor developments of the Swedish current account and the public budget. In hindsight, it is fairly clear that Sweden stuck with its unilaterally fixed exchange rate system for too long.

Lesson 1: *There is considerable evidence that the quasi fixed-rate exchange rate policy in Sweden during the 1970s and 1980s failed to serve Sweden well in light of the country's high inflation, weak competitiveness, and recurring current account deficits. Sweden fundamentally lagged behind its main competitors.* ***Thus, the exchange rate should be handled very carefully in deregulating financial markets.*** *Safety margins should be included (even in China's case, where current account surpluses have been the rule). Nervousness and speculation against the RMB cannot be ruled out if China moves ahead with marketization of its financial markets and experiences the unavoidable increase in transparency that comes with opening its financial markets to the world.*

It should be added that the real direct reason for Crisis 1 most likely was the excessive involvement of banks as credit providers to "finance companies" seeking to take advantage of an explosion in lending to the commercial real estate sector – and not a credit boom to private households. The personal income of most private Swedish households was actually quite vulnerable at that time. There had been a sharp reduction in possibilities of deducting paid interest from tax bills, several austerity packages were passed that affected the purchasing power of most Swedes very negatively, and unemployment soared.

Lesson 2: *China (and India as well) should, based on this negative Swedish example,* ***try to avoid any situation that strongly favors a rapid expansion of debt during the difficult years of financial deregulation****. China, which is currently contemplating a new strategy to give private consumption more space in total demand, ignores this advice at its own peril. It certainly would be better for China to receive its stimuli for increasing the consumption ratio from a somewhat declining contribution of investments to economic growth and from the increasing confidence of Chinese households in their own social and financial future. A further important point here: China needs to keep a careful eye on its non-bank financial institutions, regardless of whether or not they have direct links to the banking sector. Sweden more or less forgot to do appropriate oversight of its non-bank financial entities in the latter part of the 1980s – and paid dearly.*

Sweden deregulated its financial market without coordinating it with reforms of the rest of entire financial area and with other necessary economic reforms. The applied timetable was set in the following order:

Task 1: Abolish ceiling for new credit.

Task 2: Open the capital balance completely to allow cross-border financial transactions.

Task 3: Implement major tax reforms for private households, including a substantial lowering of deductions on interest payments.

It is quite obvious that Sweden should have abolished the credit ceiling *after* the complete opening of the capital balance. If this had happened, the uncontrolled and disastrous run into commercial real estate projects, both at home and abroad, could have been avoided.

Lesson 3: *Research by Edwards*[2] *and Agénor* [3] *provides a good introduction into the economics of sequencing. Goal conflicts between economic and social reforms will inevitably arise during the reform process of the relatively new Chinese leadership after the Third Plenum in November 2013.* ***These goal conflicts should be treated very carefully****.*

A second deregulation phenomenon should be briefly explained here to clarify the origins of the Swedish financial crisis of the early 1990s. Before 1989, Swedish households and institutions, with a few minor exceptions, were virtually banned from investing in foreign stocks, bonds, or real estate. Deregulation, however, happened in a period of an ongoing fast credit expansion. This was hardly optimal timing.

A substantial number of Swedish real estate investors went directly to London, Paris, Frankfurt, Amsterdam, Brussels, etc., to purchase commercial real estate. This happened (as can easily be concluded from this brief historical description) without any experience in foreign real estate markets. The herd mentality boomed. In the early 1990s, I heard comments by many of my colleagues in London, Frankfurt and elsewhere in Europe, that Swedes would pay “any price” to enter local commercial real estate markets in continental Europe and the UK. Without doubt, irrational exuberance could be noted.

Lesson 4: *China will inevitably strengthen its position further on foreign markets through financial and real investments. But, as the Swedish case in the years after the abolition of cross-border capital controls demonstrates,* ***cross-border investments carry risk, and that risk can turn out to be much more burdensome than initially anticipated.*** *In Sweden, risk exposure grew particularly high in the commercial real estate sector. In the case of China, risk management of cross-border* *investment risks should not be neglected even when China is showing surpluses in its current account. The banking sector should also be part of this allocation management and risk control.*

The new structural conditions of deregulated financial markets that generate euphoria may end in overconfidence, control illusion, and financial bubbles. This is shown by the Swedish examples and should be considered in countries where financial markets have yet to be deregulated. Psychological studies and observations of the players in both less developed and mature financial markets should be important to central bankers, bankers, academics, analysts, etc., no matter where they are. Policymakers overseeing deregulation in emerging economies should take behavioral finance and other psychological aspects particularly seriously, since most emerging economies usually lack relevant specific historical experiences of their own.

In economic terms, Crisis 1 was very costly for Sweden. GDP fell three years in a row between 1991 and 1993, altogether by roughly 5 percent. Private households were squeezed by the government's austerity packages. The open unemployment rate rose from 1 ½ percent to more than 8 percent in the first years of the 1990s.

The recovery of the Swedish economy was painful. It took several years after the turning point to substantially reduce total unemployment. Youth unemployment, even today, remains close to 20 percent, among the highest in the EU area. Indeed, this well may be the biggest failure of Swedish economic policy during the past two decades and should not be overlooked – and despite all the positive developments since financial deregulation and other reforms that followed regarding inflation, government finance, the current account, competitiveness, the pension system, entrepreneurial spirit, innovation capacity, etc.

Lesson 5: *As noted, the timing and sequencing of economic policy measures affecting financial markets can be very important, so flexibility is needed even in this respect.* ***An excess of major structural changes to the financial markets implemented within a short period of time can be counterproductive.*** *The temperature of the economy can be decisive in the proper timing of certain financial deregulations.*

Memories of earlier exuberance on financial seem to fade quickly, even if the latest bubble collapse occurred quite recently. While this phenomenon in itself is striking, things could actually get more complicated with market deregulation in a country has no historical marketization experience. In the case of Sweden during the period 1985–1991, the lack of historical experience allowed problems from deregulation of financial and credit markets to get out of hand. Even in the 2000s, the lessons from the latter part of the 1980s had yet to be taken to heart or were hidden. China and other countries should try to avoid this obvious trap!

Crisis 2: The nearly great financial crisis of 2008 and 2009

I would strongly argue that Crisis 2 of 2008 and 2009 was very much avoidable. Several Swedish banks during the 1990s made strategically logical, far-reaching investments in the banking systems of Estonia, Latvia, and Lithuania. One could even say that the Swedish Swedbank and SEB dominated the Baltic banking system at that time, both in terms of capital and market share.

At the start of the 2000s, financial structures and solidity of the three Baltic states still appeared to be at healthy levels, and the two Swedish banks made lots of money in the Baltic market. But a very unhealthy credit increase (between about 30–60 percent annually during 2004 and 2007) accelerated as macroeconomic fundamentals such as the current account and inflation simultaneously worsened sharply – without intervention by the supervisory and fiscal authorities of the three Baltic states.

Baltic current account deficit jumped from roughly 10 percent of GDP (which is already rather high) to ratios around 15 percent for Estonia and Lithuania, and over 20 percent for Latvia! At that point, monetary policy tools were ineffective at cooling down the ongoing credit explosion or slowing deterioration of the current account. The reason for this inefficiency was the formal linking of the currencies of Estonia, Latvia and Lithuania to the euro as part of the European Exchange Rate Mechanism 2 (ERM 2). This first step on the path to joining the euro meant accepting more or less fixed rates against the euro. ERM 2 meant that monetary policy in these countries had to target the exchange rate, rather than inflation, credit growth, and ultimately, domestic financial stability. This is powerful evidence that emerging countries preferably should apply floating exchange rates, because (and this cannot be overemphasized) floating exchange rates allow for independent monetary policy. Patience is needed in transitioning to a flexible exchange rate system in emerging market countries.

Lesson 6: *Generally speaking, it would be unwise to recommend that emerging countries in Asia or elsewhere go for a fast transition from a rigidly (or almost rigid) fixed exchange rate regime to a relatively flexible system of exchange rate policy. It worked for Sweden, but China should not be too ambitious in this respect.*

Instead, China and other emerging (Asian) countries working on deregulation of their financial markets should ***take time to create groups of experts representing a variety of disciplines and including independent people.*** *Such analytical surveillance and consistency may be much more complicated to apply in practice than theory would suggest.*

General policy takeaways

The lessons of these two Swedish banking crises are highlighted above. Most are also applicable to deregulating countries in Asia and elsewhere, and some even apply to the current EMU financial debt crisis.

My top ten takeaways from the Swedish banking crises are:

1. Exuberance on financial markets should never be underestimated.
2. Lack of psychological application during deregulation did not allow the credit boom to be stopped.
3. Credit booms anticipated the two heaviest post-war financial crises of Swedish banks.
4. Analytical skills was lacking at all levels of responsibility, including bank executives.
5. Crisis 1 and crisis 2 in Sweden were to a great extent aggravated essentially fixed exchange rates.
6. Financial deregulation ahead of Crisis 1 was accompanied by too many other economic policy changes.
7. Supervision and ministries did a poor job of coordinating reforms and in performing analyses of deregulation impacts overall.
8. Counter to general trend of the past decade that has relegated economists to commercial (sales) departments, at least a small group of economists should work *directly* under the executive management of financial institutions, including banks.

9. Top managers have to create better platforms for internal communication and discussion with their own analysts, and listen less to what newspapers or top executives at other institutions say about current and future risks.
10. Top managers should not allow themselves to fall prey to overconfidence.

In the shorter perspective, statistics, other economic and financial facts, as well as experience, need to be combined with qualitative research in areas such as history, psychology and institutions (including corporate governance). This approach remains the most effecting in timely uncovering of increasing financial risk before and during financial deregulation processes. Improved modeling that includes interdisciplinary factors as an additional econometric tool hold interesting analytical potential for the future, not least for research departments of central banks. Nevertheless, we need some patience before we see successful research in these increasingly important areas.

*The **big three questions** in this context are for China in the forthcoming 5–10 years:*

> *Can China successfully implement a modern domestic financial system before accomplished the trickier aspects deregulating certain parts of the capital account?*
>
> *Can China continue to post current account surpluses over the longer run? In other words, how long can China avoid net borrowing abroad? Is it a matter of years or decades?*
>
> *How rapidly will the Chinese deregulate their capital account and, thus, open up the economy to freer inflows and outflows of speculative capital?*

China and other emerging countries still have a chance to take advantage of the lessons of the Swedish financial deregulation process, including its shortcomings in sequencing and timing, i.e. inadequate coordination with other economic reforms.

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