Seppo Honkapohja

The 1980s financial liberalization in the Nordic countries

SUOMEN PANKKI
FINLANDS BANK
EUROJÄRJESTELMÄ
EUROSYSTEMET

Bank of Finland Research
Discussion Papers
36 • 2012

The 1980s financial liberalization in the Nordic countries[1]

Bank of Finland Research
Discussion Papers 36/2012

Seppo Honkapohja
Monetary Policy and Research Department

Abstract

The financial liberalization in the four Nordic countries (Denmark, Finland, Norway, and Sweden) that took place mostly in the 1980s led to a major financial crisis in three of those countries. The crises in Finland, Norway, and Sweden are among the deepest financial crises in advanced market economies since World War II. Denmark experienced some banking problems but managed to avoid a systemic crisis. This paper reviews the process of liberalization and discusses the reasons why Finland, Norway, and Sweden drifted into financial and economic crises.

Keywords: financial repression, credit rationing, capital account controls, financial deregulation

JEL classification numbers: E42, F36, G28

[1] I am grateful to Tapio Korhonen for extensive assistance. Adam Gulan, Hanna Putkuri, and Juhana Hukkinen helped in specific aspects of work. Jarmo Kontulainen and Juha Tarkka provided useful comments. The views expressed are my own and do not necessarily represent those of the Bank of Finland.

I Introduction

The banking and economic crisis that occurred in the Nordic countries in the 1990s has ever since received wide international attention. The episode was the most serious economic and financial crisis experienced by advanced market economies in the period subsequent to WWII.[2] In particular, the nearly 15% plunge in Finland's aggregate output in a period of two or three years was a surprising and unusual event.[3] The very low frequency of financial crisis in advanced economies up until the start of the 1990s should be contrasted with the relatively frequent such crises in advanced market economies before WWII. Financial crises have also occurred frequently in developing countries in the post WWI period.

Subsequently, there have been a number of other financial crises in advanced market economies throughout the world. Some of these crises have been even more severe than those experienced by the Nordic countries, so that the latter are no longer unique. Nevertheless, it is instructive to study why the Nordic countries ran into such deep economic and financial problems. Though some concurrent external factors impacted the Nordic crises (especially Finland's), it is apparent that the root causes were closely connected with the liberalizations of financial and foreign exchange markets in the 1980s and the widespread capital and credit controls in these markets in the period immediately preceding the liberalizations.

In this paper I discuss in some detail the financial liberalization processes in the Nordic countries in the 1980s and the reasons why three of the four Nordic countries – Finland, Norway and Sweden – gradually drifted into systemic financial crisis. The emphasis here on the liberalizations makes this paper complementary to the substantial literature focusing on the Nordic financial crises.

The literature includes a number of discussions of the Nordic financial crises. These articles largely focus on the crisis period and the management and resolution of the crises. Several of the studies also contain overviews of the run-up to the crisis, but the treatments are rather brief.[4] I will not consider crisis management in this paper. For this aspect, see Honkapohja (2009) and the

[2] In the beginning of the 1980s Spain suffered a serious banking crisis, as measured in fiscal costs of bank support (see eg Vives (2000). However, the Spanish GDP did not decline at that time.

[3] Reinhard and Rogoff (2008) compute the average of "big five crises" in advanced market economies before 2007 as a point of comparison for the discussion of the current crisis. The big five crises are those of Finland, Norway and Sweden in the 1990's, together with Spain in 1970's and Japan in the 1990's. Reinhart and Rogoff (2009) is an extensive treatise on different types of financial crises.

[4] See eg Drees and Pazarbaşioğlu (1998), Englund (1999), Honkapohja and Koskela (1999), Steigum (2004), Honkapohja et al (2009), Honkapohja (2009), Jonung et al (2009), Englund and Vihriälä (2009), Steigum (2009), and Vastrup (2009). Rautava (1994) gives some more details about the liberalization period in Finland.

references therein. Denmark managed to avoid the fate of Finland, Norway and Sweden, albeit experiencing banking problems, as the problems never became systemic. I hope the perspectives presented in this review are of some use for emerging economies that are thinking about initiating a process of financial liberalization.

It should be noted at the outset – and it is further explained below – that precise descriptions and detailed comparisons are difficult as regards the liberalizations in different countries. Instead I discuss at a general level various issues and problems that emerged during the liberalization. The four countries made their own assessments and decisions as to the steps along the path of liberalization. Understandably, the discussion here focuses largely on the Finnish experience, as Finland is my home country.

II General background

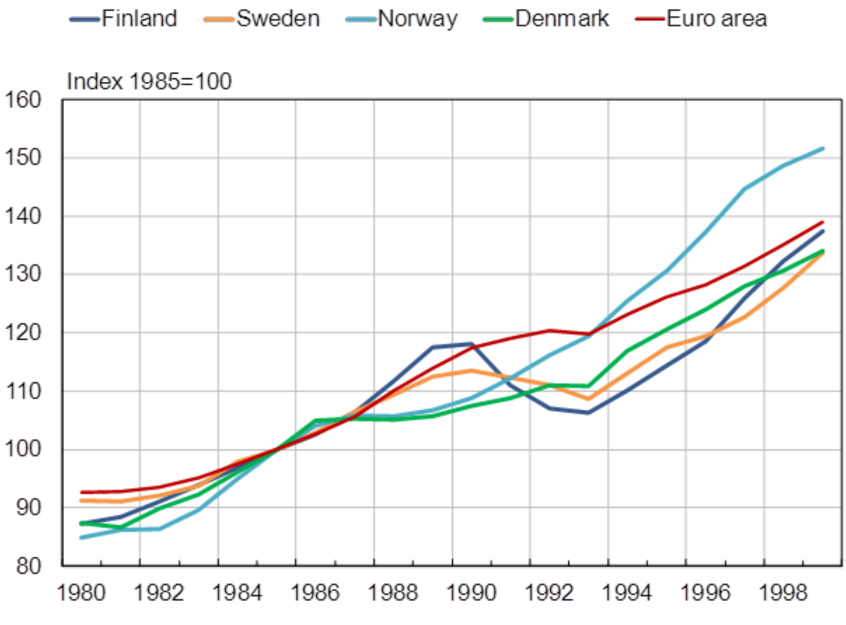
The four Nordic countries (Denmark, Finland, Norway and Sweden) are all small in economic terms and are otherwise similar, being roughly of the same size. The total population of the four was about 22 million at the end of the 1970s. Sweden is the largest, and in the decades since WWII the wealthiest of the four countries, because it managed to stay outside of the war. Finland was the weakest of the countries, partly because it suffered huge losses during the war.

The Nordic countries are known as egalitarian, socially cohesive countries, with strong western democratic traditions. The mutual ties between them are widespread and long-standing, the common Nordic labor market having been created already in 1954.

A good example of the close ties between the economies is that the countries experienced the economic crisis nearly concurrently. The Danish crisis took place earlier and was much milder and different from the other crises. As an oil-producing country, Norway had a crisis experience marked by some special features. The crises in Finland and Sweden were similar and occurred almost simultaneously, although some special features made the Finnish crisis deeper than the Swedish one.

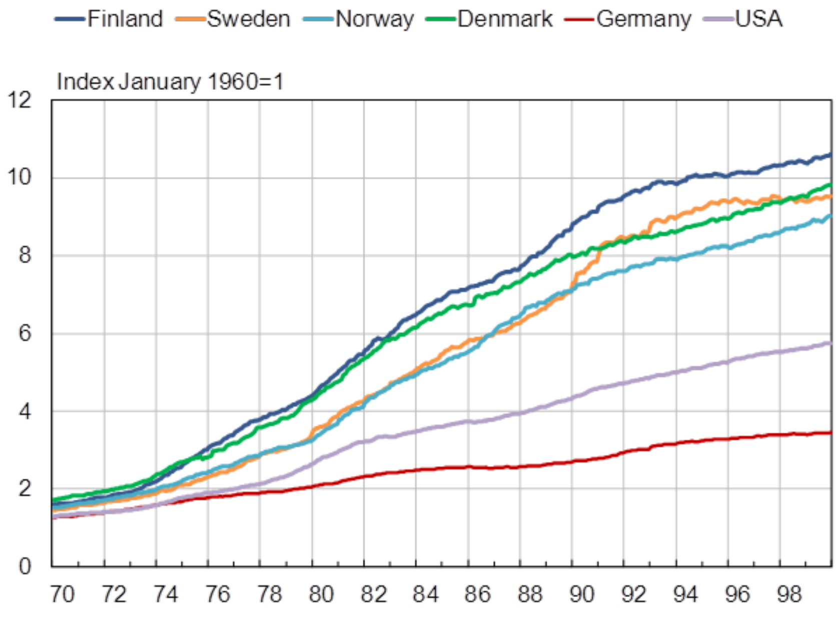
Figures 1 – 4 provide the basic data on the Nordic countries (real GDP, consumer prices, current accounts as percent of GDP, and exchange rates against the German mark). It is seen from Figure 1 that, with the exception of Sweden, GDP growth was relatively rapid, as the countries were catching up with the most advanced economies. The 1990s crises are clearly visible in the data, especially for Sweden and Finland. Figure 2 shows that inflation rates there were higher than in Germany and the United States. The Nordic countries experienced current account problems to varying degrees (see Figure 3), and the Nordic currencies depreciated against the German mark after the breakdown of the Bretton Woods system. The depreciations are shown in Figure 4.

Figure 1. Levels of Gross Domestic Product, 1980–1999



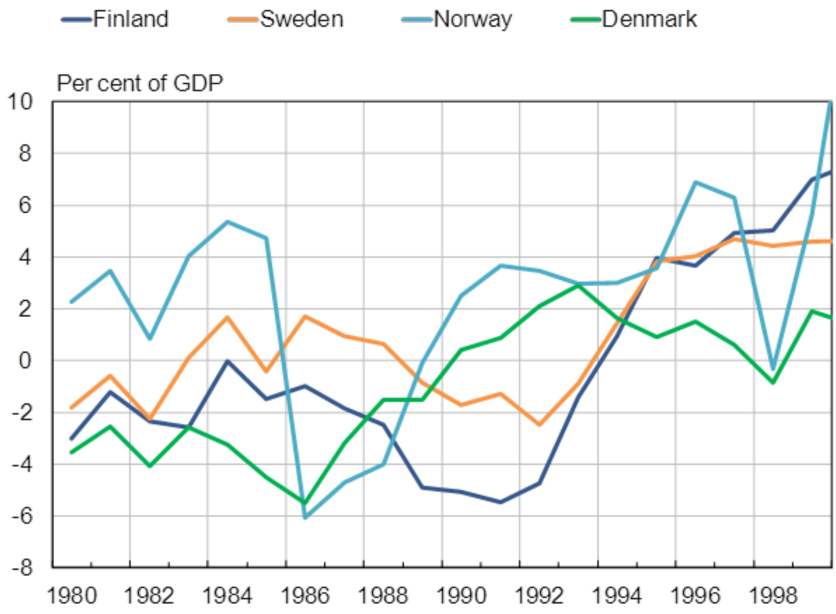
Source: Eurostat.

Figure 2. Consumer price levels, 1970–1998



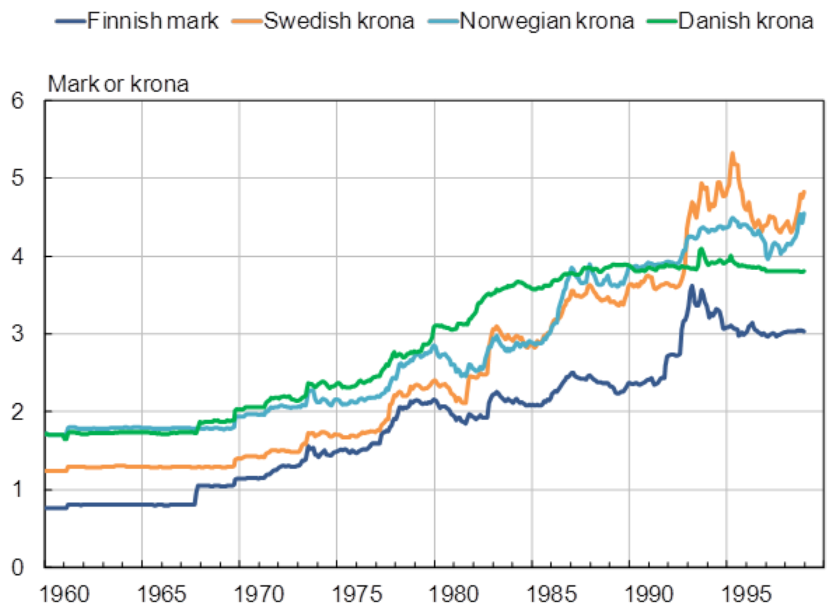
Source: OECD.

Figure 3. Current accounts in percent of GDP, 1980–1999



Source: European Commission.

Figure 4. Exchange rates against the German Mark, 1960–1999



Source: Bank of Finland.

The public sector is economically significant in all four countries, in some ways even more significant in the decades after the war. The state weighed heavily in social policy and in the economy. The Nordic governments used to own some major corporations and financial institutions, but public ownership of business has gradually declined since the 1990s. The state regulated many societal functions until the 1980s via licensing and granting of permits. For example, price controls were used in varying degrees.

The role of incomes policy was central. Together with labor market organizations, the state often made agreements on wage contracts and, as part of the agreements, sometimes the state even made commitments as to certain fiscal and monetary policy actions. Incomes policy was in fact the primary means of controlling inflation. This approach was unsuccessful in the Nordic countries - the 1970s and 1980s in particular were marked by high rates of inflation there (see Figure 2).

Comprehensive control of financial and foreign exchange markets was particularly pronounced in the decades after WWII, though some aspects of the control were inherited from the economic depression of the 1930s. However, it is worth emphasizing that the system of financial repression was mostly an instrument of the growth and industrialization policies of the post-WWII decades.[5] Rationing was largely abandoned after the war. As in the rest of Europe, foreign trade and other current account transactions and payments were liberalized already at the end of 1950s. Import duties were important until the start of the European integration process, but only agriculture remained widely protected in the Nordic countries.

III. Basic features of the control systems for capital movements and financial markets

In the decades immediately following WWII, the major Western European economies also began to liberalize capital movements, whereas the Nordic countries kept in place all the key elements of capital movement control all the way up until the 1980s.[6]

Long-term capital movements in and out of the country required a permit from the authorities. The permits were largely restricted to economic investments,

[5] Tarkka (2009) discusses the Finnish regulation system from the 1950s to the 1980s. Abilgren (2007) discusses the liberalization period and credit dynamics in Denmark.
[6] See eg Prasad and Rajan (2008), Korinek (20011), and Jeanne et al (2012) for recent discussions of the issues and problems in freeing up capital movements. The older literature on capital controls is surveyed in Dooley (1995).

whereas short-term financial investments, such as bank deposits, were not generally allowed in either direction. Of the major capital account flows, trade finance tied directly to foreign trade was relatively free. In contrast, foreign exchange for travel was rationed. Also some specific transactions, such as certain direct investments, were traditionally control-free in some of the countries.

Control of capital movements helped to maintain fixed exchange rates, among other things. The Nordic countries were part of the Bretton Woods system of fixed dollar-based exchange rates until 1971. The system was based on the so-called adjustable peg. In 1973 Denmark (which then joined the European Union), Norway, and Sweden attached themselves to the European exchange rate cooperation mechanism (the "snake") – in practice to the German Mark.[7] The latter two countries were not able to remain in the system and so exited after a few years. They began to use a trade-weighted currency basket, which Finland had already adopted.

Though the possibility of resorting to floating exchange rates was occasionally discussed, the system of fixed exchange rates was not questioned until it broke down after being hit by a storm of market pressure in 1992. This happened first in Finland but soon afterward in Sweden and Norway. The choice of exchange rate system was primarily political. The exchange rate provided an anchor especially for incomes policies. At the same time the exchange rate acted as a backstop policy instrument in case of negative economic shocks and competitiveness problems. A major consequence of the exchange rate and incomes policies was that inflation expectations were raised.

Similarity and integration of the Nordic economies was highly visible also in the currency markets. International investors tended to view the countries as a homogeneous group. Typically, pressure on the exchange rate moved from one country to the others – especially between Norway, Sweden and Finland. These countries often devalued, being forced to do so, in response to each other. Denmark was geographically, and also in terms of its economy and financing, somewhat more in tune with Central Europe.

In practice, central banks managed the currency control. The central banks' independence and duties as regards exchange-rate and monetary policies differed somewhat. Fixing the exchange rate was de facto the duty of governments[8] , and the setting of key interest rates was in practice under the direct control of the government (eg in Norway) or indirectly via representatives of parliament (in Finland).

In all the Nordic countries, control of domestic financial markets was largely focused on the banks, but other financing activities were also generally regulated.

---

[7] The "snake" was created in Europe as a system to manage exchange rates after the breakdown of the Bretton Woods system.

[8] In Sweden, this duty was formally the prerogative of the council of the Riksbank.

In the 1960s and 70s quantitative control of credit in Europe was most widespread in Norway. The annual financing budget (“nasjonalbudsjettet”), approved by the public authorities, contained the main features of finance allocation among the various sectors of the economy. This financing budget was in reality only a guideline, and the subsequent realizations deviated from it, especially in the later years. In Sweden and Denmark, quantitative rationing of finance focused on bank lending. In Sweden a large part of bank funds were directed to the government, and financed eg housing. In Finland constraints on lending were applied only from time to time, and banks usually did not significantly fund government activities. In all the countries, more or less binding directives on allocation of finance were issued in addition to the general quantitative controls.

In Denmark the securities markets were extensive and relatively free, whereas in Norway and Finland in particular the bond markets were small and not well-functioning. In all four countries, the governments fully or partly owned special financing institutions, which channelled direct finance across the economy.

Banks were mostly privately (or mutually/cooperatively) owned, but they were under extensive state control. Private commercial banks largely dominated the banking sectors. The role of local saving and cooperative banks varied somewhat between the four countries.

Banks operated under tight constraints. Quantities and allocations of credit were controlled directly or indirectly, and interest rates on bank deposits and lending, and thus the interest margin, were regulated. In addition, deposit and lending rates were controlled through taxation. Foreign items and currency positions of banks were controlled, as were fees charged by banks. Bank liquidity was secured by central bank funding, which was also a means of regulating banks via various marginal rate schedules.

This system guaranteed a banking system that was stable in terms of balance sheets and profits. A particularly notable feature of the system was that loan losses were kept at a very low level. At the same time the banking system grew substantially in terms of personnel, but its operational efficiency left much to be desired. In some countries there were attempts to limit this growth, eg by controlling the establishment of bank branch offices. Competition among banks in this environment could not be based on genuine market competition but rather on the supply of secondary customer services and advertising. Banks were viewed as a virtual branch of the government.

IV. Objectives of financial repression

Control of capital movements was necessary to secure the independence of domestic monetary policy. Control of domestic financial markets was easily maintained until the 1970s, as the Nordic economies were somewhat isolated internationally and ties to other countries largely consisted of trade relations. In Sweden some important international companies had been created. Another important feature was that all the Nordic economies were open to foreign trade already in the 1970s. Their extensive international trade was conducted under market conditions. The countries were significant exporters, for example, in the forest and engineering industries.

Financial isolation of the economy was considered important, because of the intent to use the interest rate as a policy instrument and to keep the level of interest rates low. Investments by companies and households were also supported by generous tax benefits. For example, interest payments on loans were largely or fully tax-deductible. Investment was supported in order to achieve rapid growth. Economic thinking that ascribed a minimal role to the interest rate as a policy tool also endorsed a regime of low interest rates.

The policy of supporting investment led to a number of undesirable developments. Low levels of nominal interest rates, tax benefits and high inflation kept real interest rates mostly negative in the 1970s. This led at times to a huge excess demand for loans and so to excessively tight relations between banks and their borrower-customers. A bank would virtually guarantee a loan if the borrower accumulated sufficient savings in advance. Such practices were harmful when the markets were liberalized.

On the other hand, firms were usually able to secure funding easily and cheaply, often at negative real rates, for investment in real capital formation. This favored debt financing in firms and led to excessive indebtedness. Large exporting companies in particular tried to benefit from foreign funding because of the tightness of the domestic financial markets. Interest rates on foreign currency loans were relatively low, but there was an associated currency risk. This weak financing structure of firms was detrimental when the markets were liberalized and real interest rates rose sharply.

Control of credit continued for several decades, and economic agents managed to adjust to the system. There were fears that the end of rationing could lead to unstable conditions. The period of financial repression also turned out to be one of fairly rapid growth. Though fluctuations in growth were large at times, financial crisis was averted. Control of capital movements, for example, kept the current account deficits manageable. On the other hand, it is evident that the system of controls and restrictions led to significant inefficiency in the use of economic resources. The policy of allocating finance and low interest rates resulted in very high investment rates in the Nordic economies. For instance, in Norway and Finland investment was commonly 25 – 30 percent of GDP and sometimes reached even higher levels. Despite such high investment rates, economic growth remained modest.

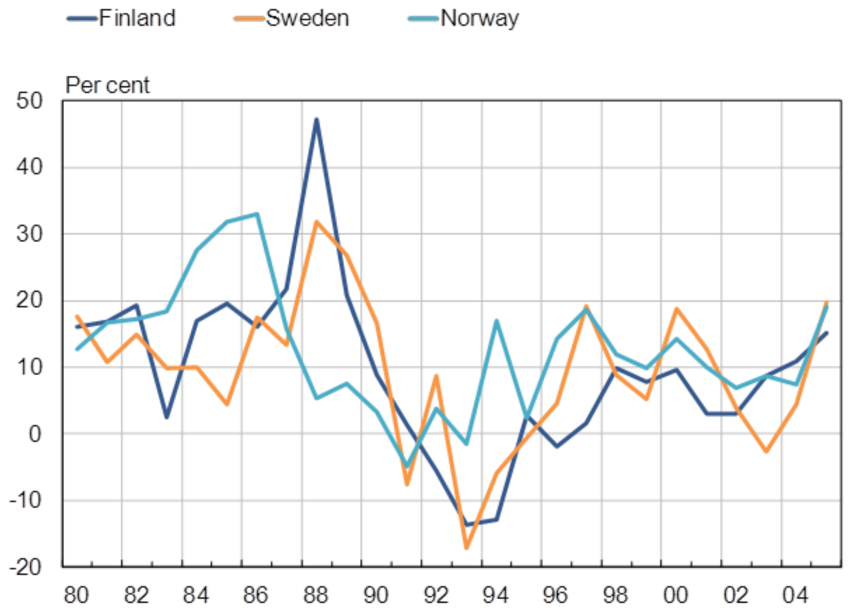
V. Starting points of the liberalization

During the period of financial repression the system was often criticized, but expressions of satisfaction with it were also widespread. Pressure to liberalize came mostly from abroad. International organizations - IMF, OECD, EU - attempted to liberalize markets as well as international capital movements, but it was the growth of international trade, internationalization of firms, and development of international financial markets that gradually broke the foundations of controls and restrictions, especially from the 1970s onward. Liberalization of foreign finance was started in Denmark already in the 1960s, but definite liberalization measures were not introduced until the late 1970s. And it was not until the 1980s that there were genuinely free money and currency markets in all four countries.[9]

The liberalizations led to some volatility in macroeconomic developments, certain aspects of which can be seen from Figures 1-4 above. In particular, current accounts were persistently in deficit (with the exception of Norway), and the deficits worsened during the process of liberalization. Moreover, the countries experienced lending booms to varying degrees, and there were major increases in real estate and share prices. Figures 5-7 show the growth rates of bank lending, real house prices and real share prices in the four countries.

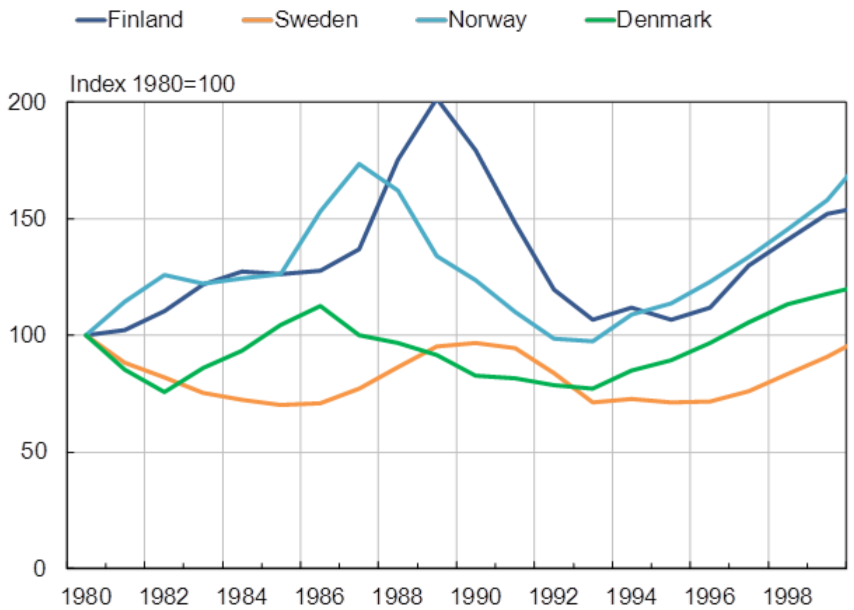
[9] Danish data are not included in Figure 5 for reasons of non-comparability.

Figure 5. Growth of bank lending, 1980–2005



Sources: OECD and Bank of Finland.

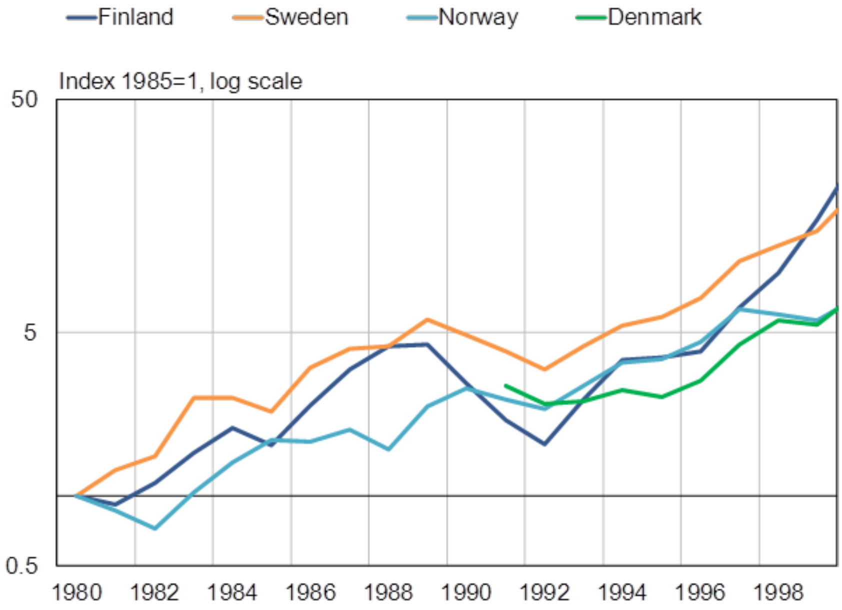
Figure 6. Real house prices, 1980–1999



Nominal house prices deflated using the consumer price index.

Sources: Statistics Finland, Statistics Sweden, Norges Bank, Statistics Norway and Bank of Finland.

Figure 7. Real share prices, 1980–1999



Nominal share prices deflated using the consumer price index.

Sources: IMF, ECB and Bank of Finland.

It is in general difficult to measure the degree of freedom and regulation in different countries, so that it is also difficult to compare the Nordic countries as regards their liberalization processes.[10] The IMF has put some effort into developing indices of the degree of regulation of international capital movements. Even nowadays, foreign finance is not fully free in any country; for example, there are still certain limitations on the export of banknotes – as a means of limiting criminal activities.

This renders highly uncertain any interpretation of individual regulations and liberalization. Often the image that emerges from a list of liberalization activities of different countries is incomplete and even misleading. A seemingly modest action may have surprisingly large effects, especially when the state of the market or economy changes in an essential way. On the other hand, a seemingly large action may simply mean that certain realities are confirmed. For example, if control of certain currency transactions has already been quite loosely applied, the formal freeing of these transactions is not a significant decision.

The tight control of financial transactions in Nordic countries relied on a "negative principle" in which the main rule was a ban: regulations specified the permitted activities; everything else was forbidden. As markets became more

[10] Englund and Vihriälä (2009) for illustrative figures of the liberalization steps in Finland and Sweden.

developed and relatively free, the rule book thickened. For this reason it was and still is difficult to compare the rules of regulating countries and their significance.

Another difficulty was that the rules, for example, regarding permits were applied in a variable fashion. Permits were granted at times stringently or loosely, depending on the business cycle or currency market pressures. Countries can also differ with respect to the degree of avoidance of regulation, both legally and illegally. The Nordic countries are constitutional states, so that evasion of controls was undoubtedly limited, except for the last period of regulation. In the final stages, frustration with leakages and loopholes in the controls accelerated the abolishment of restrictions. Evasion of regulations was mostly fully legal after the expansion of possibilities for avoidance as the markets developed further.

In the final stages of controls and restrictions there was also a move to the "positive principle", so that everything not forbidden was permitted. In this stage specific activities were kept on the forbidden list. For example, in Finland foreign currency loans for households were permitted only in the late stages of liberalization – luckily, as it was then too late to exacerbate the economic crisis of the 1990s.

VI. Importance of the order of liberalization steps

Objectives for the reform of the economic-policy framework in part determine how the liberalization of different markets is carried out. The freeing of financial and foreign currency markets limits the domestic leeway of economic policy in important ways. In an economy with repressed financial markets it is possible to fix all three of the following instruments: exchange rate, domestic interest rate, and quantity of finance. As is well known, in free markets it is impossible to fix all three of these at the same time; the remaining magnitudes are determined by the markets. This is called the impossible trinity.

This simple fact was in principle understood in the Nordic countries, but at the same time it was difficult to accept the lack of the policy autonomy in practice. There should have been a willingness to abandon the idea of fixing either the exchange rate or interest rate when capital movements were freed. However, political realities precluded this, except in Denmark. The consequence was a difficult balancing act between the adjustable peg and interest rate policy. The outcome was evidently suboptimal in all countries.

Everything looks much clearer with the benefit of hindsight. There has been much criticism to the effect that liberalization was not realized in accord with a coherent and consistent plan. Already during the liberalization process, some studies were done in the different countries about the best ways to proceed with liberalization. It is difficult to say to what extent the guidelines offered could have been applied in practice. In the initial stages of the process it was not widely accepted or perhaps even considered desirable that the objective was to move to fully deregulated markets and capital movements. Almost until the end of the process the intention was to maintain some controls on at least some of the capital movements. The deeper European integration process starting at the end of the 1980s was the main reason for the complete liberalization of financial activities.

As mentioned above, pressure to liberalize financial and foreign exchange markets came partly via international policy cooperation and partly via market forces, as the economies gradually become more internationalized. Capital movements became more elastic as a result of increasing foreign trade, the emergence of multinationals and the development and widening of their financing sources. Especially those companies engaged in foreign trade became associated with informal “grey” domestic financial intermediation outside the banking system and beyond the direct control of regulators. The grey financial market became widespread in the late 1970s. This rendered impossible to control quantitatively the total financing of the economy, which had earlier been a central objective. The existence of grey markets influenced the decisions and sequencing of steps in the liberalization of markets.

There are two main concerns regarding the liberalization of markets:

1) Does one first liberalize the domestic financial markets (quantities, interest rates on loans, deposit rates, distorting taxes) or international capital movements and currency markets?
2) In what order are the different markets to be freed in terms of maturity and other characteristics (short-term finance, long-term finance, finance of different sectors, derivative markets etc.)

Further issues in the freeing of international capital movements include the following:

1) Does one liberalize foreign currency-denominated or domestic currency-denominated quantities simultaneously or in some particular order?
2) Does one liberalize imports and exports of capital in the same way and simultaneously?
3) Does one liberalize in response to market pressure, ie free up capital imports when there is pressure for capital exports and vice versa?
4) In what situations and to what degree is it justified to reverse the liberalization steps?

The common view is that domestic financial markets should be liberalized first. The domestic markets would then be more prepared to withstand the pressures of opening the economy to international forces. On the other hand, it has been argued that only the freeing of capital movements would force domestic financial markets to adjust to the new environment.

The Nordic countries moved in reality so that both domestic markets and foreign transactions, ie currency markets and capital movements, were liberalized more or less in tandem. Some small foreign operations were in fact freed first. However, most important domestic deregulation activities were carried out faster and somewhat ahead of important liberalizations of capital movements.

By the early 1980s it had become evident in all the Nordic countries that there was no alternative to moving toward free domestic financial markets and also toward mostly free foreign capital movements. A market-based domestic financial system was operational in all these countries by the end of the decade. For example, market-based reference interest rates were adopted following the example of London LIBOR rates. The central banks' steering mechanisms became market-based and definite elements of control in the form of rationing were discarded.

The Nordic countries adopted somewhat different ways to carry out the process of liberalization of different markets. In general it would have probably been justified to free long-term, foreign currency-denominated operations first. Denmark started by freeing sales abroad of long-term bonds and even of domestic currency-denominated bonds. In general, the financing of firms was freed of restriction in the first wave. Certain operations of banks and other financial institutions were freed gradually. Banks' possibilities for lending abroad were restricted even in the beginning of 1980s, as Nordic countries generally avoided the international (Latin American) banking crisis of the time.

Liberalization of liquid items of banks and firms was an important issue from the viewpoint of implementing monetary policy. If a country's foreign reserves are highly sensitive to negative economic shocks and subject to wide fluctuations, they could be exhausted in the event of devaluation speculation. On the other hand, revaluation speculations made it difficult to control domestic liquidity, which in turn raised the risk of overheating and inflation.

Forward contracts in currencies used to hedge commercial risk were allowed early on, subject to the requirement of commercial base, within limits, but derivatives markets in general were freed up only in the late stages of liberalization.

Liberalization of markets was not quite a unidirectional process. On a few occasions rationing was tightened in some countries, when the deregulation process was thought to endanger the orderly development of liquidity and possibilities of control via monetary policy.

The Nordic countries followed the common international practice, according to which there was greater readiness to free up capital imports than capital exports. This was understandable in a less than perfectly credible system of fixed exchange rates. In practice, it was attempted to liberalize capital movements in a countercyclical manner. If pressures to import capital were leading to a rapid easing of domestic money markets, controls on capital exports were reduced, while controls on capital imports were kept unchanged or even tightened. On the other hand, when there were pressures to export capital, there was a tendency to ease controls on capital imports. For a long time, structural considerations made it desirable to limit exports of capital. It was feared – and to some extent justifiably so on the basis of later evidence – that investors, including banks, would be wide-eyed and would rush to make international investments. The control of capital exports exercised by central banks, however, did not usually deliver very good results.

During the period of controls, the Nordic currencies were not traded in the international markets, but they – especially the Swedish krona – were to an extent used as invoicing and settlement currencies. As a matter fact, internationalization of a country's money was viewed with some caution. Of course, Nordic monies, as small inflationary currencies, were initially rarely sought after by international investors. For example, the foreign sales of Finnish markka-denominated debt securities were free, but there was very little investment in them until the early 1980s. Denmark was an exception, as it allowed foreign sales of krone-denominated bonds and the amounts involved were non-trivial. This meant that Danish long-term interest rates began to be determined in large part in foreign markets.

In particular, there were fears that large foreign investors might bring instability to the domestic money markets. Thus there were attempts to restrict foreign investors' use of domestic currency right up until the end of the liberalization period. On the other hand, it was increasingly prognosticated that widening the base and diversity of investors might instead actually stabilize market conditions. The possibilities for investing domestic currency abroad were naturally restricted as long as there was control of domestic money and financial market interest rates.

As corporations became increasingly active on the international stage and, for example, inflation receded, the foreign demand for Nordic currencies significantly increased in the early years of 1980s. One reason was the occasionally high interest rate. As in Denmark, increased investments in the Finnish domestic markets created liquidity problems, which in fact led to the breakdown of the system based on tight controls. The outcome was a two-tiered interest rate system, in which the importance of grey market rates gradually increased. Eventually, official interest rates no longer reflected the cost of credit. Consequently, monetary policy started to lose its grip on monetary developments in the economy.

Decisions on taxation are central for economic policy in the context of liberalizing the financial markets. Tax systems favoring debt finance were typical for the period of financial repression. This form of taxation had created distortions among the different forms of finance. It would have been important to give up these tax benefits early on, but this turned out to be impossible for political reasons. Decisions concerning tax benefits for loans and deposits were made quite late in the liberalization process, and only in the context of banking and economic crisis.

VII. The timing of liberalization

Liberalizations in the Nordic countries led to a variety of problems, which turned into full scale crises in the end. This outcome can be contrasted with the experiences of Western European countries which carried out the liberalization of markets earlier or concurrently. The latter generally did not experience nearly as serious problems as the Nordics. This was the case even though most other European countries pursued steady policies with fixed exchange rates, albeit with the support of the European Monetary System.[11]

The Nordic countries tried to free up the financial and foreign exchange markets gradually and carefully to avoid risks, but they did not succeed. In contrast, and against the advice of numerous experts, Margaret Thatcher freed foreign capital movements and currency markets “overnight” in 1979 in the UK. Financial stability in Britain was not greatly disturbed by the speedy action.

A regime of floating exchange rates was perhaps the UK’s main advantage in the reform process, but it was helped by the well-developed domestic markets and the City, as well as a stable external environment. It is evident that success depends in large part on the degree of economic stability in foreign countries as well as on financial developments in the critical stage of liberalization. Apparently, Denmark was successful in this respect, whereas for Sweden and especially Finland the most critical stage of liberalization occurred in a very adverse external environment.

In practice, economic and political realities dictated the timing of liberalization in the Nordic countries. Sometimes measures were adopted in the throes of market pressure.

[11] Empirical evidence on the connection between banking crises and exchange rate regimes is mixed; see Domaç and Peria (2003).

This meant that it was not always possible to carefully plan in advance the various stages of liberalization. Thus some measures were decided in uncommon circumstances, which made for unpredictable consequences of a reform measure. This was the case, when under international pressure the price of oil fell sharply in 1985-86. At that time Finland and Sweden were pursuing expansionary policies and, for example, capital imports were being liberalized. As a result of the fall in oil prices, the economic situation domestically and around the world abruptly reversed course, so that policy measures already in track turned out to be very badly timed. This contributed to an unwanted overheating of the economy, especially in Finland.

VIII. Controls and liberalization as the backdrop for crisis

Undoubtedly one of the basic mistakes in the liberalization was that the planning narrowly focused on sensible execution of the liberalization process. It would have been better to have simultaneously analyzed how a financially repressed economy differs from a market based economy. And it would have been important to promote the flexible transformation of controlled markets and sectors into an unregulated system.

Insufficient attention was paid to the adjustment of markets and sectors in the Nordic countries. The starting point focused too much on how and in what order one can dispense with a system of controls, and there was too little attention paid to the condition of banks and other market institutions and sectors. It was thought that firms and households know how to adjust and are able to do so in a flexible way, to a new system requiring a very different kind of behavior. However, it turned out that both banks and their customers moved toward the new equilibrium too rapidly, which caused a credit boom, an asset price bubble, and eventually a banking crisis.

It was not sufficiently realized that liberalization leads to increased risks. Prudential supervision did not play a significant role during the period of a controlled financial system, because the control mechanism by itself had in large measure secured the stability of banks. Some banking problems occurred in the decades after WWII, but there had not been any system-wide crises in the Nordic countries. Because such a possibility was not even contemplated, there was a lack of readiness to manage a systemic banking crisis. Capital ratios of banks were quite low in the Nordic countries in the era of controls, with the exception of Denmark where bank solvency was better.

The Nordic countries naturally tracked international trends in prudential supervision, but their supervisory praxis was judicial and technical. The focus was solely on individual banks and their risk positions. It would have been important to focus on stable adjustment of the banking sector as a whole and on the macroeconomic risks attached to banking in the context of market liberalization.

Liberalizations led to major changes in the economic behavior of different sectors, which contributed to the emergence of economic and banking crises in all the Nordic countries. The most important events in the main sectors were the following:

1) an eruption of unsatisfied demands for loans by households and small and medium-size businesses,
2) the realization that firms' financial structures were not healthy (too much debt, too little equity),
3) a consequent weakness of firms in weathering fluctuations in financing costs and exchange rates,
4) after the initial boom period, there was a pronounced tightening of competition between banks, so that excess capacity and lack of management competence became destabilizing factors,
5) liberalized capital movements led to significant instability in the fixed exchange rate regime.

Households in particular, including entrepreneurial ones, had faced severe constraints during the period of credit control. Advance saving was required for housing loans and consumer loans were rare. The average maturity of a household loan was also very short. As the markets were liberalized, the built-in pressures erupted, and the number of potential loan customers increased substantially. Banks responded to the increase in demand by preparing for a lending boom, and volume of household loans surged.

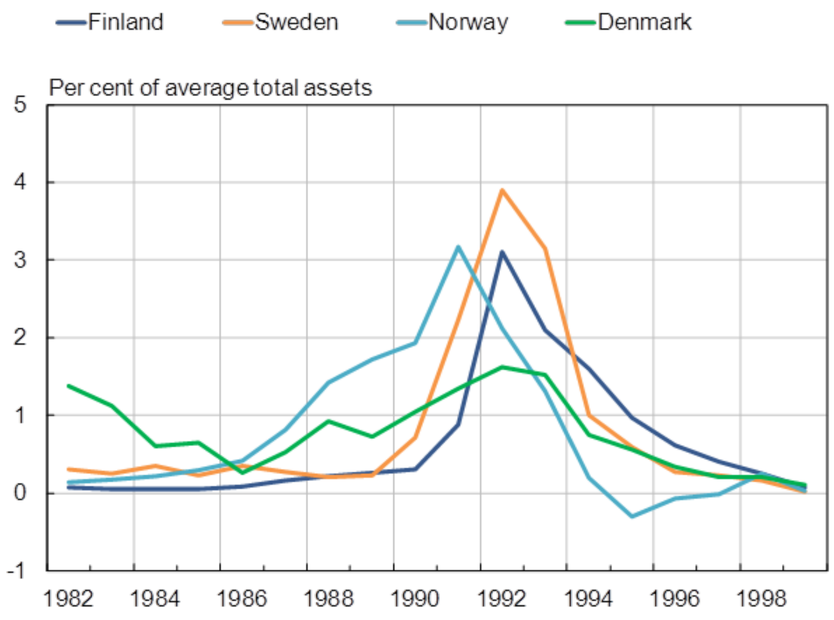
The same situation applied to small and medium-size firms to an extent. On the other hand, firms obtained favorable financing and tax treatment for their investments, so that their situation was partly the opposite of that of households. Firms had too much of both domestic and foreign currency-denominated debt to begin with. Especially in Finland, firms had taken out excessive amounts of foreign currency loans. When the real rate of interest rose sharply in the course of the liberalization and as exchange rate pressures emerged, many firms faced a difficult situation.

The banking system proved to be inefficient and oversized in terms of real resources (personnel, branch network) as a result of the financial repression period. Banks understood the need for change, but they reacted in different ways. It would have been natural to trim personnel and activities, but some banks chose instead a strategy of expansion aimed at making use of their excess capacity at the expense of their competitors. This strategy was successful during the initial period of strong economic growth, but the depression which followed came as a surprise to these aggressive banks. In Finland, especially the savings banks, and in Norway, some commercial banks, got into overwhelming difficulties and were taken over by authorities and wound up. Banks were not accustomed to dealing with credit losses and, except for the Danish banks, the deepening crises led to large percentage losses in outstanding loans.

The system of controlled finance had guaranteed a relatively stable development of the financial markets. Financial institutions, especially banks, were thought to be almost eternal. Crisis awareness and preparedness was insufficient among banks and also among government officials. The crises following liberalization transformed the Nordic financial market institutions in various and surprising ways. Some banks were wound up and merged into other banks.

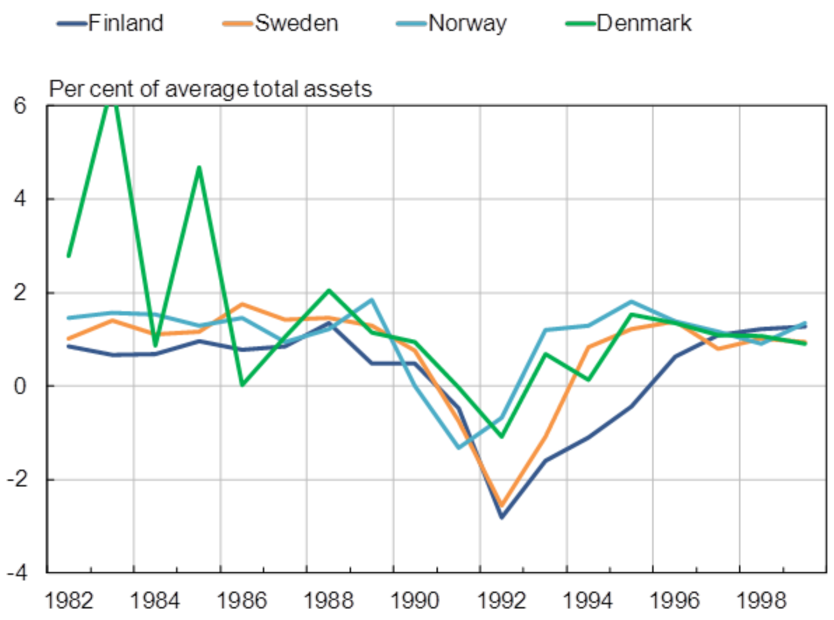
Figure 8 shows that realized loan losses soared with the onset of economic crisis. As discussed above, Denmark experienced the lowest losses, as it avoided a systemic crisis. The Norwegian crisis also evolved gradually, but it turned into a severe one. In Sweden and Finland the losses came quickly. Correspondingly, Figure 9 shows that the profitability of Nordic banks plummeted in the crisis years. In Denmark, banks' profitability gyrated already in the early 1980s, as a result of the earlier liberalization and reforms, and the decline in profitability in the 1990s was then relatively small. It can also be seen that Norwegian banks did somewhat better in terms of profitability than Swedish and Finnish banks. Especially in Finland, the period of negative profits lasted quite long, about five years.

Figure 8. Loan losses of Nordic banks, 1982–1999



Source: National central banks.

Figure 9. Operating profits of Nordic banks, 1982–1999



Source: National central banks.

The crisis in Denmark was the earliest and mildest. Apparently, Denmark managed to liberalize early and in a relatively favorable external environment. Capital ratios of Danish banks were much better than in the other countries, and the growth of household indebtedness had been discouraged by tax measures since 1986. The Norwegian crisis differed from the Swedish and Finnish crises because of the oil producing sector. This sector strengthened the economy after the 1970s, and the sharp fall in oil prices in 1986 mitigated the overheating of the economy. Therefore, the crisis in Norway primarily involved the banking sector and did not include a serious economic recession.

The Swedish and Finnish economies became overheated at the end of the 1980s, immediately after the liberalizations. These countries would have required a calm period in order to repair the structural problems that had arisen during the period of controlled finance and its liberalization. Unfortunately, the bubble burst almost concurrently with the onset of the international recession in the early 1990s. Exceptionally high interest rates and overvalued currencies made the problems worse. The 1991 breakdown of the Soviet Union led to the evaporation of some 20 percent of Finnish foreign trade, and a major devaluation of the markka in conjunction with a large overhang of foreign currency-denominated loans contributed to the severity of the economic depression.

The instability of Nordic economies, especially Finland, Sweden and Norway, in the late stages of liberalization and during the crises was clearly influenced by the aim of these countries to maintain a regime of fixed exchange rates on their own. In contrast, the Danish currency was supported by the European Monetary System, and its credit facilities were financed foreign exchange interventions.

Strong pressures for currency devaluations and revaluations built up during the period of liberalization. After the 1982 devaluations, the countries experienced pressure to import capital, while at times capital tended to move out. At the end of the decade, Finland and Sweden in particular faced pressures from capital imports. Developments in Norway were somewhat different because of the oil.

As the international and domestic business cycles turned toward a recession at the turn of the decade, the countries encountered mounting speculative pressures, which led to high interest rate policies and a deepening of the recessions. Also the levels of international interest rates were high as a result of German interest rate policies. With liberalized foreign exchange markets, this had a decisive impact on the Nordic countries.

Facing the pressure of recession, Finland, Sweden and Norway – after long and rather expensive defensive actions – were obliged to abandon the fixed exchange rate system. Initially, there were suspicions about the floating exchange rate. However, a floating rate, combined with the adoption of inflation targeting regime, worked surprisingly well during the 1990s. Financial development was clearly much smoother than in the preceding decade. In a sense the shift to a floating exchange rate in 1992 marked the end of a long period of financial repression and its aftermath in the Nordic countries.

References

Abilgren, K. (2007): Financial Liberalization and Credit Dynamics in Denmark in the Post World War II Period, Danmarks Nationalbank, Working Papers 47.

Domaç, I. and M.S.M. Peria (2003): Banking Crises and Exchange Rate Regimes: Is There a Link?, Journal of International Economics, 61, 41-72.

Drees, B. and C. Pazarbaşioğlu (1998), The Nordic Banking Crisis: Pitfalls in Financial Liberalization, IMF Occasional Paper 161.

Dooley, M.P. (1995): A Survey of Academic Literature on Controls over International Capital Transactions, NBER Working Paper 5352.

Edey, M. and K. Hviding (1995): An Assessment of Financial Reform in OECD Countries, Economics Department Working Paper 154, OECD Paris.

Englund, P. (1999): The Swedish Banking Crisis: Roots and Consequences, Oxford Review of Economic Policy, 15, nr.3, 80-97.

Englund, P. and V. Vihriälä (2009): Financial Crises in Finland and Sweden: Similar but Not Quite the Same, in Jonung, L., J.Kiander and P. Vartia (Eds.): The Great Financial Crisis in Finland and Sweden, Edward Elgar, 71-130.

Gourinchas, P.-O., R. Valdés, O. Landerretche, E. Talvi and A.V. Banerjee (2001): Lending Booms: Latin America and the World, Economia, 1, 47-99.

Honkapohja, S. (2009): The 1990s Financial Crises in Nordic Countries, Bank of Finland, Discussion Papers 5, 2009.

Honkapohja, S. and E. Koskela (1999): The Economic Crisis of the 1990s in Finland, Economic Policy, 29, 401-436.

Honkapohja, S., E. Koskela, W. Leibfritz and R. Uusitalo (2008): Economic Prosperity Recaptured: the Finnish Path from Crisis to Fast Growth, MIT Press.

Jeanne, O., A. Subramanian and J. Williamson (2012): Who Needs to Open the Capital Account?, Peterson Institute for International Affairs.

Jonung, L., J. Kiander and P. Vartia (2009): The Great Financial Crisis in Finland and Sweden: the Dynamics of Boom, Bust and Recovery, in Jonung, L., J.Kiander and P. Vartia (Eds.): The Great Financial Crisis in Finland and Sweden, Edward Elgar, 19-70.

Korinek, A. (2011): The New Economics of Capital Controls Imposed for Prudential Reasons, IMF Working Paper 11/298.

Prasad, E.S. and R. Rajan (2008): A Pragmatic Approach to Capital Account Liberalization, NBER Working Paper 14051.

Rautava, J. (1994): The Finnish Experience with Financial Market Liberalization: Some Lessons for Economies in Transition, in Bonin, J.P., and I.P. Székely (Eds.): The Development and Reform of Financial systems in Central and Eastern Europe, Edward Elgar, 196-213.

Reinhard, C.M. and K.S. Rogoff (2008): Is the 2007 US Sub-Prime Financial Crisis So Different? An International Historical Comparison, American Economic Review, 98, 339-344.

Reinhard, C.M. and K.S. Rogoff (2009): This Time Is Different, Eight Centuries of Financial Folly, Princeton University Press.

Steigum, E. (2004): Financial Deregulation with a Fixed Exchange Rate: Lessons from Norway's Boom-Bust Cycle and Banking Crisis, in More, T.G., J.A. Solheim and B. Vale (Eds.): The Norwegian Banking Crisis, Norges Banks Skriftserie/Occasional Papers No.33, 23-75.

Steigum, E. (2009): The Boom and Bust Cycle in Norway, in Jonung, L., J.Kiander and P. Vartia (Eds.): The Great Financial Crisis in Finland and Sweden, Edward Elgar, 202-244.

Tarkka, J. (2009): Financial Regulation in Finland from the 1950s until the 1980s, Stability at what Price?, in Gigliobianco, A. and G. Toniolo (Eds.): Financial Market Regulation in the Wake of Financial Crises: The Historical Experience. Banca d'Italia Workshops and Conferences Vol. 1. (November 2009).

Vastrup, C. (2009): How Did Denmark Avoid a Banking Crisis?, in Jonung, L., J.Kiander and P. Vartia (Eds.): The Great Financial Crisis in Finland and Sweden, Edward Elgar, 245-264.

Vives, X. (2000): Lessons From European Banking Liberalization and Integration, in Claessens, S. and M. Jansen (Eds.): The Internationalization of Financial Services, Kluwer Law International (UK), 177-198.

BANK OF FINLAND RESEARCH
DISCUSSION PAPERS

ISSN 1456-6184, online

1/2012 Maria Teresa Punzi **Housing market and current account imbalances in the international economy.** 2012. 27 p. ISBN 978-952-462-784-9, online.

2/2012 Luisa Lambertini – Caterina Mendicino – Maria Teresa Punzi **Expectations-driven cycles in the housing market.** 2012. 61 p. ISBN 978-952-462-785-6, online.

3/2012 George A. Waters **Quantity rationing of credit.** 2012. 26 p. ISBN 978-952-462-786-3, online.

4/2012 Karlo Kauko **Why is equity capital expensive for opaque banks?** 2012. 26 p. ISBN 978-952-462-787-0, online.

5/2012 Kaushik Mitra – George W. Evans – Seppo Honkapohja **Fiscal policy and learning.** 2012. 32 p. ISBN 978-952-462-788-7, online.

6/2012 Ian W. Marsh – Wolf Wagner **Why is price discovery in credit default swap markets news-specific?** 2012. 41 p. ISBN 978-952-462-789-4, online.

7/2012 Katja Taipalus **Signaling asset price bubbles with time-series methods.** 2012. 47 p. ISBN 978-952-462-790-0, online.

8/2012 Paavo Miettinen **Information acquisition during a Dutch auction.** 2012. 22 p. ISBN 978-952-462-791-7, online.

9/2012 Diego Moreno – Tuomas Takalo **Optimal bank transparency.** 2012. 33 p. ISBN 978-952-462-792-4, online.

10/2012 Alina Barnett – Martin Ellison **Learning by disinflating.** 2012. 20 p. ISBN 978-952-462-795-5, online.

11/2012 Bill Francis – Iftekhar Hasan – Qiang Wu **Do corporate boards affect firm performance? New evidence from the financial crisis?** 2012. 55 p. ISBN 978-952-462-796-2, online.

12/2012 Bill Francis – Iftekhar Hasan – Liang Song **Are firm- and country-specific governance substitutes? Evidence from financial contracts in emerging markets.** 2012. 55 p. ISBN 978-952-462-797-9, online.

13/2012 Chung-Hua Shen – Yu-Li Huang – Iftekhar Hasan **Asymmetric benchmarking in bank credit rating.** 2012. 40 p. ISBN 978-952-462-798-6, online.

14/2012 Bill Francis – Iftekhar Hasan – Qiang Wu **Corporate governance and cost of bank loan.** 2012. 49 p. ISBN 978-952-462-799-3, online.

15/2012 Isabelle Distinguin – Iftekhar Hasan – Amine Tarazi **Predicting rating changes for banks: How accurate are accounting and stock market indicators?** 2012. 34 p. ISBN 978-952-462-800-6, online.

16/2012 Bill Francis – Iftekhar Hasan – Liang Song – Bernard Yeung **What determines bank stock price synchronicity? Global evidence.** 2012. 46 p. ISBN 978-952-462-803-7, online.

17/2012 Bill Francis – Iftekhar Hasan – Kose John – Maya Waisman **Urban agglomeration and CEO compensation.** 2012. 64 p. ISBN 978-952-462-804-4, online.

18/2012 Manthos D. Delis – Iftekhar Hasan – Pantelis Kazakis **Bank regulations and income inequality: Empirical evidence.** 2012. 45 p. ISBN 978-952-462-805-1, online.

19/2012 Iftekhar Hasan – Tania De Renzis – Heiko Schmiedel **Retail payments and economic growth.** 2012. 37 p. ISBN 978-952-462-806-8, online.

20/2012 Ari Hyytinen – Jukka Lahtonen – Mika Pajarinen **Entrepreneurial optimism and survival.** 2012. 49 p. ISBN 978-952-462-807-5, online.

21/2012 Ari Hyytinen – Hanna Putkuri **Household optimism and borrowing.** 2012. 45 p. ISBN 978-952-462-808-2, online.

22/2012 Juha Kilponen – Helinä Laakkonen – Jouko Vilmunen **Sovereign risk, European crisis resolution policies and bond yields.** 2012. 24 p. ISBN 978-952-462-809-9, online.

23/2012 Andrés Fernández – Adam Gulan **Interest rates and business cycles in emerging economies: The role of financial frictions.** 2012. 48 p. ISBN 978-952-462-810-5, online.

24/2012 Timo Korkeamäki – Tuomas Takalo **Valuation of innovation: The case of iPhone.** 2012. 40 p. 978-952-462-811-2, online.

25/2012 Martin Ellison – Thomas J. Sargent **Welfare cost of business cycles in economies with individual consumption risk.** 2012. 19 p. 978-952-462-812-9, online.

26/2012 Yiwei Fang – Bill Francis – Iftekhar Hasan **More than connectedness – Heterogeneity of CEO social network and firm value.** 2012. 56 p. 978-952-462-815-0, online.

27/2012 Jess Benhabib – George W. Evans – Seppo Honkapohja **Liquidity traps and expectation dynamics: Fiscal stimulus or fiscal austerity?** 2012. 33 p. 978-952-462-818-1, online.

28/2012 Bill B. Francis – Iftekhar Hasan – Xian Sun **Does relationship matter? The choice of financial advisors.** 2012. 56 p. 978-952-462-819-8, online.

29/2012 Matti Viren **How can growth be accelerated in Europe?** 2012. 15 p. 978-952-462-820-4, online.

30/2012 George A. Waters **Careful price level targeting.** 2012. 11 p. 978-952-462-821-1, online.

31/2012 Bill B. Francis – Iftekhar Hasan – Xian Sun **Home preference at selecting financial advisors in cross-border M&As.** 2012. 48 p. 978-952-462-822-8, online.

32/2012 Maria Kopsakangas-Savolainen – Tuomas Takalo **Competition before sunset: The case of the Finnish ATM market.** 2012. 29 p. 978-952-462-827-3, online.

33/2012 Henri Nyberg – Pentti Saikkonen **Forecasting with a noncausal VAR model.** 2012. 38 p. 978-952-462-828-0, online.

34/2012 Maritta Paloviita **Fiscal planning and implementation: euro area analysis based on real time data.** 2012. 24 p. 978-952-462-829-7, online.

35/2012 Maritta Paloviita **Real time uncertainty in fiscal planning and debt accumulation in the euro area.** 2012. 29 p. 978-952-462-830-3, online.

36/2012 Seppo Honkapohja **The 1980s financial liberalization in the Nordic countries.** 2012. 25 p. 978-852-462-831-0, online.

http://www.suomenpankki.fi/en • email: Research@bof.fi
ISBN 978-952-462-831-0, ISSN 1456-6184, online