DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES

SPECIAL COMMITTEE ON THE FINANCIAL, ECONOMIC AND SOCIAL CRISIS

THE NORDIC CRISIS

WORKSHOP

Abstract

A workshop on the "Nordic Crisis - Lessons from the Nordic Countries in the Early 1990s for the Present Crisis" was held in the European Parliament in Brussels on 30 November 2009. This document contains the programme and presentations of that workshop.

IP/A/CRIS/WS/2009-1 December 2009

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This document was requested by the European Parliament's Special Committee on the Financial, Economic and Social Crisis.

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Workshop Programme

The Nordic Financial Crisis

Lessons from the Nordic Countries in the Early 1990s for the Present Crisis

30 November 2009
European Parliament, Brussels
Room PHS 1A002, 16.00-18. 30
Interpretation available

Chair: Wolf Klinz (MEP, ALDE), CRIS Chairman

16.00 - 16.05 **Introduction - Wolf Klinz, CRIS Chairman**

16.05 - 17.00 **Presentations by Experts**

Topics discussed: What happened in Sweden (and Finland) in the beginning of the 1990s? Why and how were the decisions taken as they were taken? What can we learn from it today?

Experts: Lars Nyberg

Deputy Governor, Riksbank, Swedish Central Bank

Lars Jonung

Professor, Research Adviser, DG ECFIN, European Commission

Jaakko Kiander

Research Professor, Labour Institute for Economic Research, and University of Helsinki

17.00 - 18.30 **Discussion with MEPs**

Curricula Vitae of Speakers

Lars Nyberg, *Deputy Governor, Riksbank, Swedish Central Bank*

Lars Nyberg is Deputy Governor of the Riksbank, the Swedish central bank. He has been appointed by the Government to the Board of Finansinspektionen (the Swedish Financial Supervisory Authority) and is the Riksbank's representative in the group of deputies for the G10 Ministers and Governors and in the ESCB's Banking Supervision Committee. Mr Nyberg is an associate professor in economics and has previously been Deputy CEO at Svenska Handelsbanken and Swedbank and CEO of Länsförsäkringsbolagens förening. Lars Nyberg is the Riksbank's spokesperson regarding financial stability and a safe and efficient payment system. Lars Nyberg's term of office is six years from 1 January 2006. He was appointed to the Executive Board of the Riksbank in 1999 and has been re-elected twice.

Lars Jonung, *Professor, Research Adviser, DG ECFIN, European Commission*

Lars Jonung is since September 2000 Research Adviser at DG ECFIN, European Commission, Brussels, primarily working with macroeconomic issues in a European context. He was previously professor of economics at the Stockholm School of Economics. His research is focused on monetary and fiscal policies, particularly on the policy of the *Riksbank*, monetary unions and exchange rate arrangements, inflationary expectations and perceptions, business cycle issues, and the history of economic thought. Jonung has authored and edited several articles and books in English and Swedish. He served as chief economic advisor to Prime Minister Carl Bildt in 1992-94. He was economic advisor to the *Skandinaviska Enskilda Banken* in 1989-91. In addition he has contributed to several Swedish government investigations.

Jaakko Kiander, *Research Professor, Labour Institute for Economic Research, and University of Helsinki*

Jaakko Kiander is Director of the Finnish Labour Institute of Economic Research. He is also Research Professor at the Government Institute for Economic Research in Finland (VATT) as well as visiting professor at the University of Helsinki. His main fields of interest include macroeconomic policy and economic crises, labour economics, integration and migration, technology policy as well as technological and social capital. Notably, he is also programme manager of the Academy of Finland Research Programme on the economic crisis in the 1990s. Previously, Kiander has held various positions in policy research and has been Research Director at the Finnish Government Institute for Economic Research before joining the Finnish Labour Institute of Economic Research. He has published widely on his subjects of interest in Finland and internationally.

Presentations

Presentation by
Lars Nyberg

Deputy Governor of the Riksbank

SVERIGES
RIKSBANK

What's Old, What's New?

Brussels 30 Nov, 2009
Mr Lars Nyberg
Dep. Gov., Sveriges Riksbank

SVERIGES
RIKSBANK

My Main Messages

- Bad lending by banks was the root of the present crisis as well as the Swedish one.
- Similar solutions were required and used.
- But in 1992, Swedish banks were sick and the world was OK. Now the opposite.
- International cooperation is increasingly important to prevent and to deal with crises
- EU should continue its leading role.

What caused the banking crisis in Sweden in 1991-1993?

- Mistakes in deregulation, fiscal policies, tax policies. Fx-policy contributed to the crisis.
- Macroeconomic boom and bust
- Financial sector weaknesses – excessive lending, concentration risks, overreliance on collateral.
- Weaknesses in non-banks (gaps in supervision)
- Regulatory and supervisory deficiencies

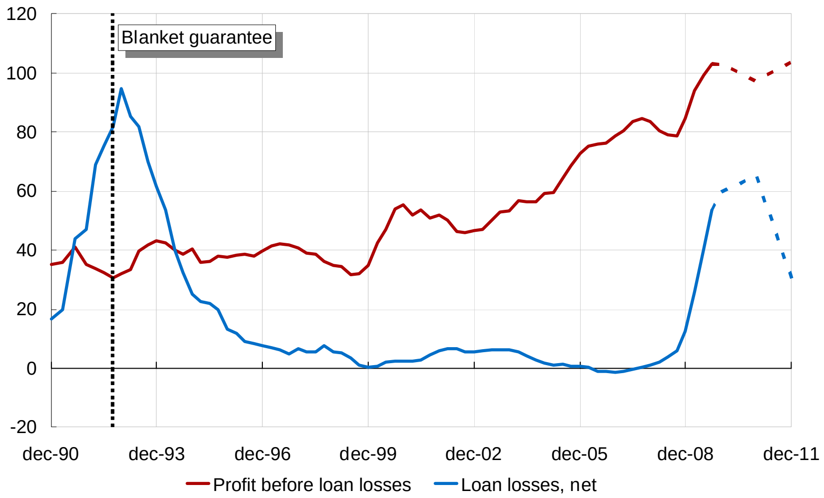
2008 global crisis - What is similar?

- *Underlying causes*. Bad lending, regulatory and supervisory failures, policy deficiencies
- *Manifestation*. Big losses in the financial system (not only banks). Falling confidence. Systemic character.
- *Measures*. Liquidity and capital support. Resolution of failed institutions.

2008 global crisis – What is different?

- Not only banks, but much broader
- Across markets (credit/securities/liquidity)
- Across borders
- Major liquidity problems due to several factors. Total loss of confidence
- Originate–and–distribute business model
- New non-transparent instruments; use of SIVs

Profits and losses during the Swedish crisis



The Blanket Guarantee

- Highly potent, potentially dangerous (moral hazard; level playing field) measure…
- …but sometimes necessary to restore confidence and create a pause for a considered crisis resolution.
- In Sweden in 1992 it stopped the currency outflows from the banks and from the country and restored confidence.

Not all Swedish banks…

- SHB - stayed clear
- SEB - a private equity issue
- Savings banks - Govt loan + loan guarantee
- Co-operative bank – Govt capital guarantee – not utilised.
- Nordbanken - Full nationalisation; split into good bank/ bad bank
- Gota Bank – Govt takeover; split into good/bad bank. Good bank merged with Nordbanken.

What we did right

- Political consensus
- No favours to bank owners
- Strict transparency requirements
- Bad assets transferred to AMCs at conservative values

- All the above contributed to restoring confidence both domestically and abroad

AMCs important

- - careful valuation and transfer of assets
  - make value of good bank transparent
  - focus bank management on good bank
  - improve asset values for later sales
  - recruit special expertise
  - restart weak asset markets

Lessons from old and new crises

- More and better bank capital needed
- More and better liquidity buffers needed
- Adequate financial stability analysis – and instruments if action is needed
- Consider cross-border aspects
- Be prepared for crisis management and resolution!
- Cooperation MoF – NCB – FSA (also across borders) in peace time as well as in crisis.

What remains to do?

- Harmonisation and updating of regulation/supervision. Close gaps.
- Identify macroprudential risks
- Cross border issues – e.g. burden sharing; harmonisation of cross-border resolution; deposit guarantees.
- Dealing with systemic firms. Too big to fail/rescue?

Prepare for crisis!

- We have allowed the banks to work in the EU open market – and gained from that.
- But we have not provided proper legislation for crisis management and resolution – particularly not for cross border banks.

Fragmentation is not the solution

- Mergers (as means of crisis resolution) can be used to create stronger and more diversified banks.
- Nordbanken + Gota = supplementary in geographical coverage in Sweden.
- Nordea = supplementary coverage in all Nordic countries.
- Nordea: Strong in current crisis, partly due to diversification.

Preparing for Resolution

- Recovery and resolution plans for individual banks (living wills)
- Establish effective and harmonized resolution regimes
- Ex ante coordination between home and host authorities

How could the EU contribute?

- Europe should continue its lead in creating international rules and institutions for:
  - Better regulation and supervision (ESA)
  - Stronger rules on capital and liquidity
  - Macroprudential risks (ESRB)
  - *Crisis management and resolution*

Presentation by
Lars Jonung

Professor, Research Adviser, DG ECFIN, European Commission

DG ECFIN

The Swedish model for resolving the banking crisis of 1991-93.

Seven reasons why it was successful

Prepared for the workshop:
The Nordic Financial Crisis. Lessons from the Nordic Countries in the Early 1990s for the Present Crisis

30 November 2009, European Parliament, Brussels, Room PHS 1A002, 16.00-18. 30

Lars Jonung

Research adviser, professor
Directorate-General for Economic and Financial Affairs (DG ECFIN)
EUROPEAN COMMISSION, Brussels

The views expressed are my own and should not be attributed to the European Commission

DG ECFIN

Source:

The presentation is based on an Economic Paper published by DG ECFIN:

"The Swedish model for resolving the banking crisis of 1991-93. Seven reasons why it was successful.

European Economy, Economic papers 360, European Commission, February 2009, Brussels.

http://ec.europa.eu/economy_finance/publications/publication_summary14130_en.htm

DG ECFIN

The anatomy of the financial crisis of the early 1990s

The Swedish financial crisis in the 1990s:

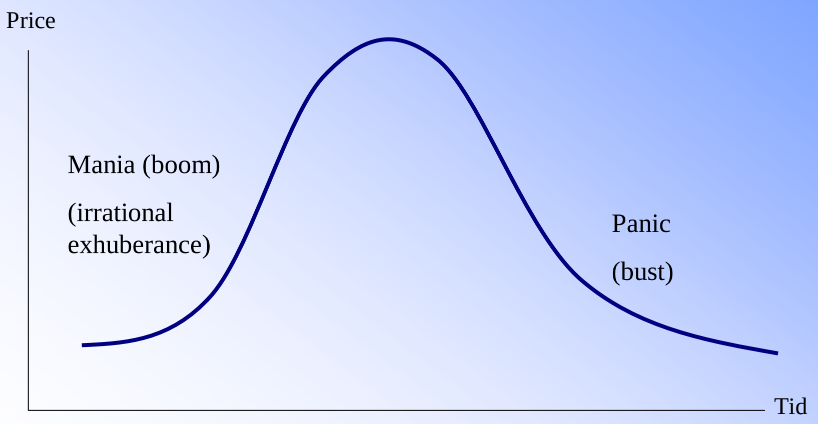
A ”classical” story of boom and bust triggered by financial liberalization cum a fixed but adjustable exchange rate, expansionary monetary and fiscal policies, lax financial supervision, lack of financial knowledge.

Financial crises are due to:
Bad policy, bad regulation, bad banking and bad luck

Sweden had it all. Like Finland and Norway at the same time.

DG ECFIN

The anatomy of the financial crisis of the early 1990s. A stylized view: Boom 1985-1991 - bust 1991-1993 - recovery 1993-2001



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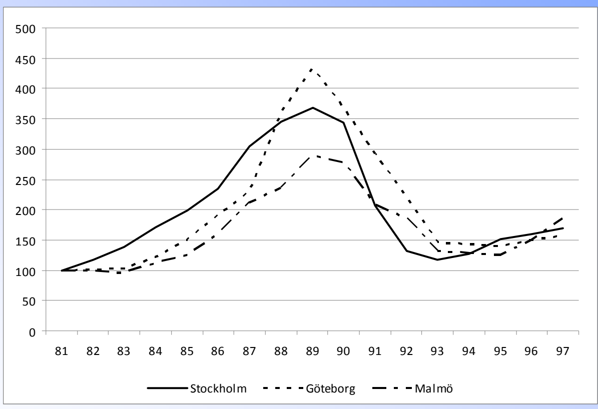
The traditional boom-bust pattern as demonstrated by the real price of commerical real estate in Stockholm, Göteborg and Malmö, 1981-1997. Index = 100 for 1981.



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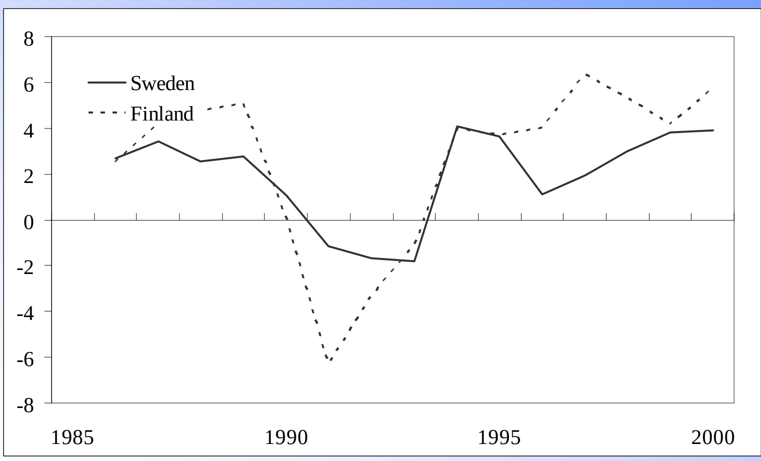
The anatomy of the financial crisis of the early 1990s
Real GDP growth



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The Swedish model for bank resolution

1. Political unity

A central feature of the Swedish model was the political unity underlying the bank resolution policy from the very start. This unity was initially created by the determination of the political parties to defend the pegged exchange rate of the krona, and it persisted throughout the crisis.

The Centre-Right government and the political opposition - the Social Democrats - joined forces and avoided making the banking crisis a party political issue.

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The Swedish model for bank resolution

2. Blanket guarantee of bank deposits and liabilities

The Swedish government, in cooperation with the opposition, announced in a press release on September 24, 1992 – a critical month when the currency pegs in several European countries were successfully attacked – that depositors and other counterparties of Swedish commercial banks and Swedish financial institutions in which the State was involved were to be fully protected from any future losses on their claims.

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The Swedish model for bank resolution

3. Swift policy action

Once it was fully understood that a serious financial crisis was in the making, the government, the parliament and the Riksbank responded by taking decisive steps to support the financial system and, in particular, banks in distress.

In this way the confidence of depositors and counterparties in the financial system was strengthened at an early stage of the financial crisis. This made it possible to maintain this confidence throughout the resolution of the crisis at a relatively low political cost.

Swift action kept any uncertainty regarding policy measures to a minimum.

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The Swedish model for bank resolution

Of course, there was a risk that a rapid policy response might be too rapid …

As a staff member of the Riksbank involved in the resolution process said: “It is more important to act early than to get it exactly right.”

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The Swedish model for bank resolution

4. An adequate legal and institutional framework for workout procedures based on open-ended funding

*In December 1992, the Riksdag, passed legislation by an overwhelming majority and with no political infighting to establish a Bank Support Authority, **Bankstödsnämnden**, as envisaged in the press release of September 24, 1992.*

This step was taken when the crisis had deepened and it had emerged that not only the liquidity, but also the solvency of several commercial banks was at stake. The original stepwise, ad hoc approach had now turned into a more systemic approach.

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The Swedish model for bank resolution

The parliament decided that the Bankstödsnämnden was to be given open-ended funding, not a fixed predetermined budget.

This was a deliberate choice in order to avoid the risk that the Bankstödsnämnden would be forced to go back to the Riksdag to ask for additional funding at a later stage.

The Bankstödsnämnden was set up as an independent agency which kept its distance from the government, the Riksbank and the financial supervisory agency. This construction fostered credibility and trust in the operations of the Bankstödsnämnden.

The Swedish model for bank resolution

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5. Full information disclosure

From the very start, the Bankstödsnämnden sought to obtain a clear picture of the financial problems facing the financial institutions through due diligence. It tried to draw - whenever appropriate - on the available expertise for dealing with ailing banks by consulting and using external experts, many of whom were recruited from abroad.

Banks that turned to the Bankstödsnämnden with requests for support were obliged to give full disclosure of all their financial positions, opening their books completely to scrutiny by the Bankstödsnämnden.

This requirement facilitated the resolution policy, as well as making it acceptable in the eyes of the public.

The Swedish model for bank resolution

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6. Differentiated resolution policy aimed at maintaining the banking system and preventing moral hazard

Banks that turned to the Bankstödsnämnden were dealt with in a way that minimised the moral hazard problem. In short, the aim was to save the banks – not the owners of the banks. By forcing owners of banks to absorb losses, public acceptance of the bank resolution was fostered. In this way, taxpayers were likely to feel that the policy was fair and just.

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The Swedish model for bank resolution

Two bank asset management corporations (AMCs), Securum and Retriva, were set up to manage the bad debt (non-performing loans) of financial institutions as part of the resolution policy - as had been the case in other countries.

A novel approach was adopted which involved splitting the assets of an ailing bank into "good" and "bad" assets, and then transferring the "bad" assets to the asset management corporation, principally to Securum.

In the long run, the two bank asset management corporations proved to be successful, in the sense that the fiscal cost of supporting the financial system was roughly balanced out by the revenues received by the bank asset management corporations from the liquidation of their asset holdings.

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The Swedish model for bank resolution

7. The role of macroeconomic policies to end the crisis

The bank resolution policy in Sweden was facilitated by the design of monetary and fiscal policies to counteract the crisis once it had peaked in the autumn of 1992. These measures allowed the Swedish economy, and hence the financial system, to recover fairly rapidly.

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The Swedish model for bank resolution

Once the krona was floating in November 1992, monetary policy was able to focus on domestic conditions. The Riksbank gradually lowered interest rates, although critics claimed that the reductions were too cautious.

The vicious circle of falling asset prices was arrested. The ensuing fall in interest rates eased the pressure on the banking system, as the economy started to recover.

In July 1996, the crisis legislation and the blanket guarantee were abolished.

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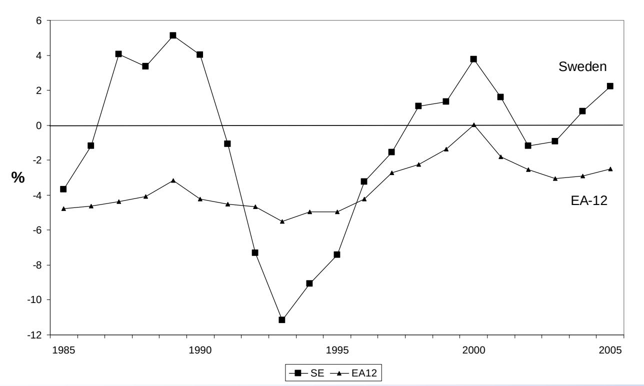
The Swedish model for bank resolution

Figure 1. The budget deficit to GDP in Sweden and the EA 12, 1985-2005. Percent



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3. Evaluating the Swedish bank resolution

The Swedish bank resolution policy is commonly regarded as successful in the international policy debate:

- The banking system remained fairly intact,
- There were no bank runs,
- The banking system was swift to move out of the crisis.
- The banking system remained privately owned and became profitable shortly after the crisis.
- The cost to the taxpayer was low in the long run

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4. Can the Swedish model be exported?

To what extent can the Swedish model be exported and applied to other countries today?

To answer this question, the Swedish crisis of the early 1990s has to be compared to the present global crisis.

There are considerable similarities and also considerable differences.

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Can the Swedish model be exported?

On a very general level the similarities are striking.

The causes of the two crises are similar. The impulse driving the boom that preceded the crisis can be traced to financial liberalization, financial innovations, and lax monetary policy setting off a credit boom in the US, later spreading to the rest of the world.

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Can the Swedish model be exported?

But …

The Swedish crisis of the early 1990s was primarily a local phenomenon, or – more accurately - a Nordic one, as Finland and Norway also went into crisis at roughly the same time as Sweden.

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Can the Swedish model be exported?

The option of an export-oriented growth strategy out of the crisis is currently not open to EU, because the present crisis is a global one. An individual country can no longer rely on the rest of the world to maintain aggregate demand for its exports, as Sweden was able to do in the 1990s.

Sweden had the advantage of being a small player that could rely upon the stability of the rest of the world to support its domestic recovery.

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Can the Swedish model be exported?

The small size of the Swedish financial system in the 1990s facilitated the bank resolution policy.

Policy-makers dealt with a limited number of banks - only six major banks.

The Swedish system was also bank-based, with few major financial actors outside the banking system.

This is in sharp contrast to the United States today, for example, where there are a large number of banks of different types and many non-bank financial actors.

Can the Swedish model be exported?

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The Swedish bank resolution policy was also confronted by a financial system that was much less sophisticated and much less globalized than the financial systems of today.

There were no structured products, no sophisticated derivatives, hardly any hedge funds, a more limited supply of financial instruments than today, less securization etc.

Can the Swedish model be exported?

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In addition, Sweden has a long tradition of confidence in its domestic institutions, in the political system and in its elected representatives.

With this large social capital, it is easier for the government and the opposition to reach agreement on public policy actions that are stable and lasting.

The tradition of open public debate makes it easier for policy-makers to explain difficult decisions to the public and to be trusted.

It may be difficult for other countries to mobilize the same type of social capital that was needed in order to make the Swedish approach successful.

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It was easier for policy-makers in the early 1990s to deal with a local financial crisis in a small open economy like Sweden's than deal with a global crisis characterised by strong and sophisticated financial cross-border links as of today.

The international financial linkages suggest a need for international cooperation, in particular within the EU.

5. Summary

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The conclusions from the Swedish experience must be that the process of support to the financial system would gain from

a basis of political unity,

speed and transparency

an open, consistent and all-encompassing strategy,

a legal and institutional framework where the administration of the support is left to experts acting at arm's length from the government, the central bank and the financial supervisory agency.

support should be open-ended and its aims should be, first, to guarantee both the liabilities of banks and, second, to ensure the solvency of the financial system by a system of recapitalization of banks.

support should be so designed as to appear fair and just to the public. Moral hazard should be kept at a minimum by avoiding bail-outs of shareholders.

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These conclusions from the Swedish case are easy to summarize.

However, when exporting them and applying them to other countries, attention should be paid to differences in the initial conditions.

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The Swedish model for resolving the banking crisis of 1991-93.

Seven reasons why it was successful

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Lars Jonung

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The views expressed are my own and should not be attributed to the European Commission

Presentation by Jaakko Kiander

Research Professor, Labour Institute for Economic Research, and University of Helsinki

THE GREAT DEPRESSION OF FINLAND 1990-1993: causes and consequences

Jaakko Kiander

Labour Institute for Economic Research

CONTENTS

- Causes – background
- The crisis
- Consequences
- Role of economic policy
- Banking crisis
- Recovery
- Reflections on the current crisis

Background of the crisis: financial market deregulation

- Until the 1980s the Finnish banking sector and international capital flows heavely regulated – low risks, no credit losses
- Financial deregulation in the 1980s, following international pattern
- After gates were opened, a flow of foreign credit increased rapidly domestic liquidity 1986-89
- Credit expansion fuelled an investment boom and asset price bubble in 1987-90

Favourable fundamentals justified optimism

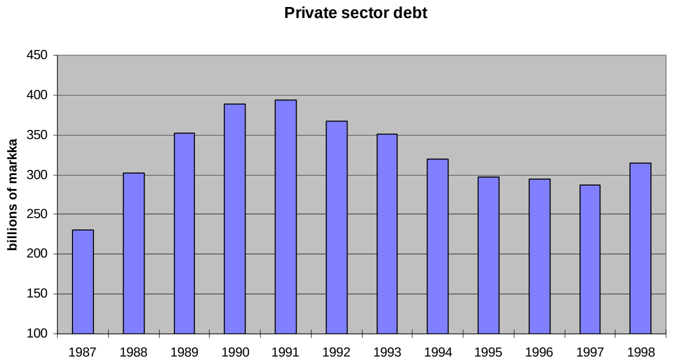
- Exports were supported by improved terms-of-trade and by rapid European growth 1986-1989
- Finland seemed a lucrative place to invest
- The policy of fixed exchange rates helped to maintain investor confidence and created an illusion of low exchange rate risk in foreign currency borrowing

Strong growth led quickly to overheating and indebtedness

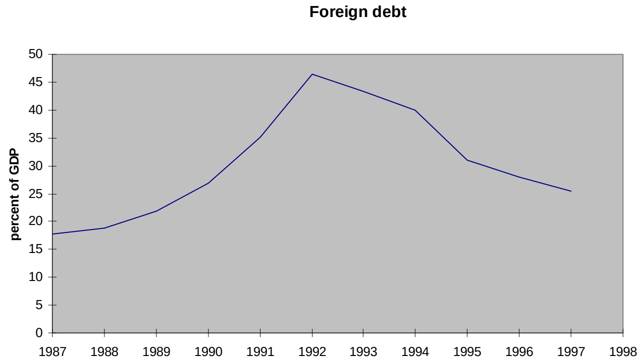
The latter half of the 1980s was characterized by:

- rapid growth of output, consumption and investment
- consumer price and asset price inflation
- widening current account deficit (to 5 % of GDP), increasing foreign debt but stable debt/GDP-ratio (25 %)
- full employment and good fiscal balance, very low public debt
- inflation & currency appreciation increased the Finnish price level in relative terms so that finally it was 40 percent higher than OECD average (in 1990)

Private sector debt was doubled within 4 years



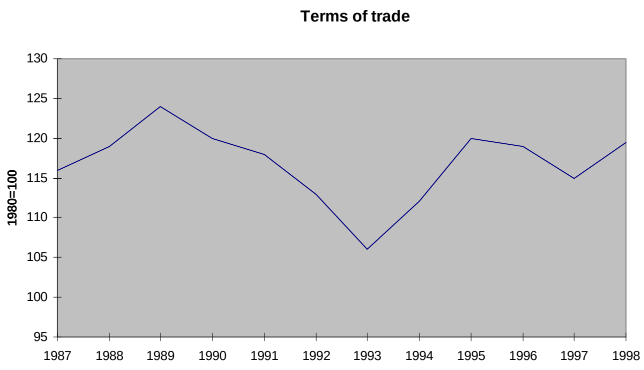
Foreign debt became a problem only after currency depreciation and output fall in 1991-93



Negative shocks changed the economic outlook in 1989-91

- Slowdown of international economy and rising European interest rates in 1990-93
- The collapse of Soviet Union and Finnish-Soviet trade in 1990-91: a negative export shock of 10 percent
- Decreasing terms of trade (due to declining export prices and rising oil price) together with appreciation of real exchange rate led to declining competitiveness and profitability

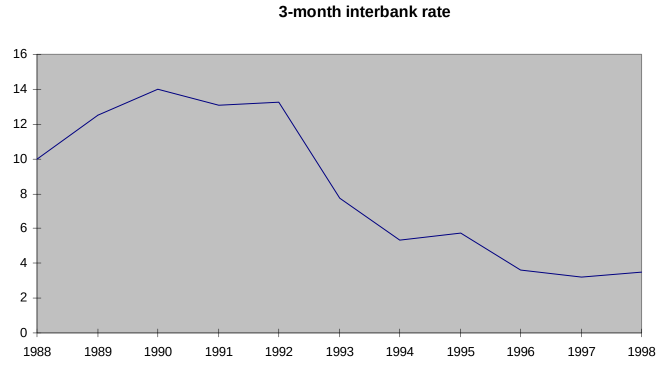
Cyclical variation of terms of trade



Strong currency became overvalued in 1989-91

- (foreign) investors and forex markets started to lose confidence in the stability of exchange rate
- As a result, waves of speculative attacks against the fixed exchange rate -> pressure on currency reserves
- Central bank's response: defend the exchange rate with high interest rates – on average 13 percent in 1989-1992
- Policy priority: in order to avoid devaluation a deflationary adjustment was chosen – depress demand and cut wages (=internal devaluation)

Period of high interest rates



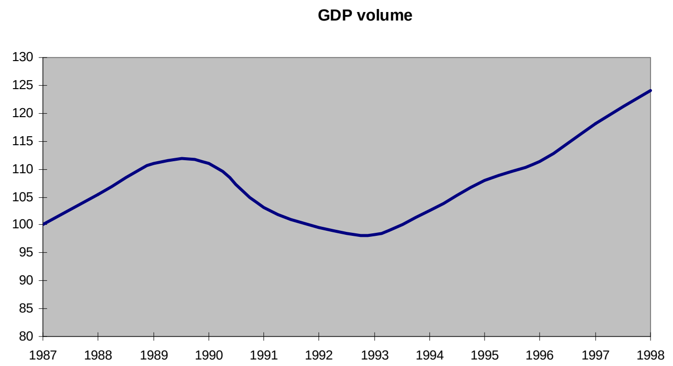
High real interest rates started a deflationary process

- private investment was reduced by 50 percent in 1990-1993
- private consumption was reduced by 10 percent in 1990-1993
- export earnings were reduced by 10 percent in 1991 – but exports recovered quickly in 1992
- stock market collapsed by 70 percent in 1989-1992 and house prices fell by 50 percent – enormous negative wealth effect
- GDP fell by 13 percent from mid 1990 to mid 1993 – mainly because of collapsing domestic demand (-20 %)

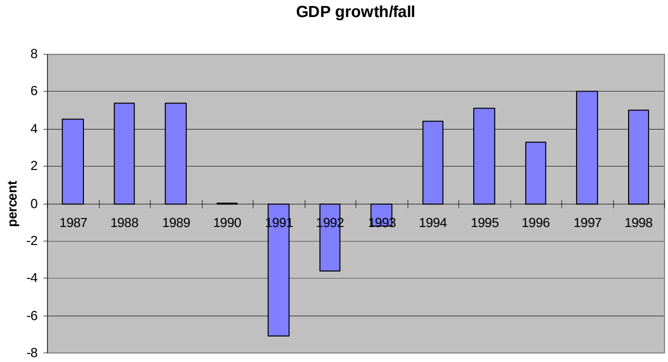
Balance sheet adjustment

- The main reason to the crisis was the need to readjust private sector balance sheets – to deleverage banks, firms, and indebted households
- This process was accelarated by high interest rates and shift in expectations (or ’animal spirits’) from optimism to pessimism
- If all agents try to reduce indebtnedness at the same time, a collapse in aggregate demand follows

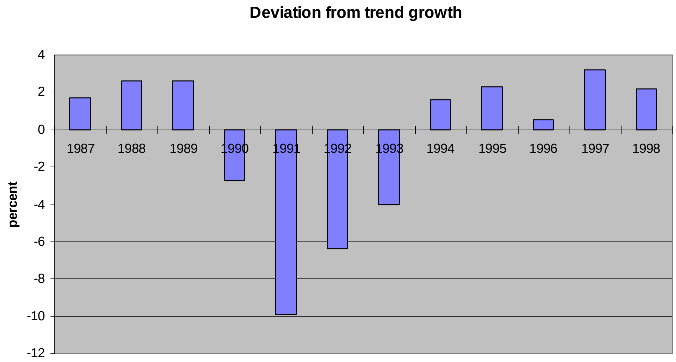
A 5 year slump in GDP volume



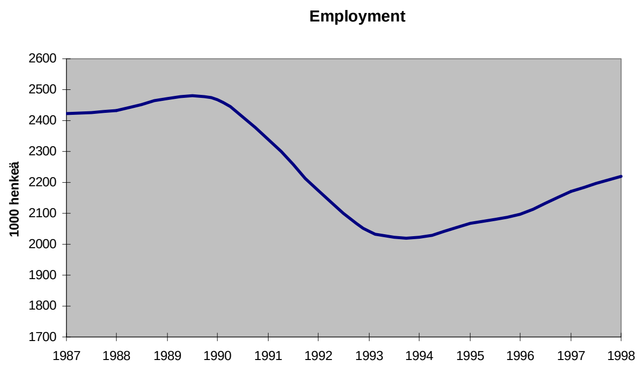
Four years without growth, three years with falling output



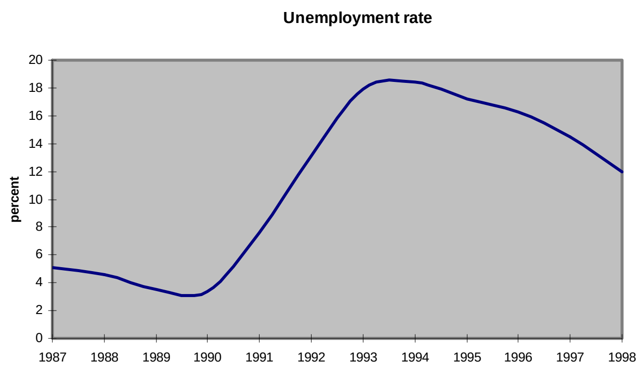
A 20 percent cumulative deviation from potential GDP



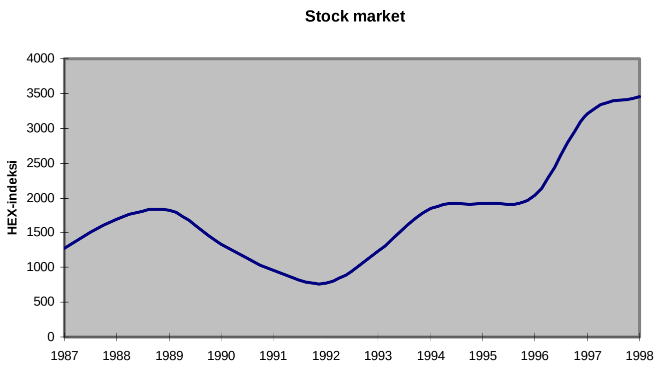
Employment was reduced by 20 percent (and 450 000 jobs lost)



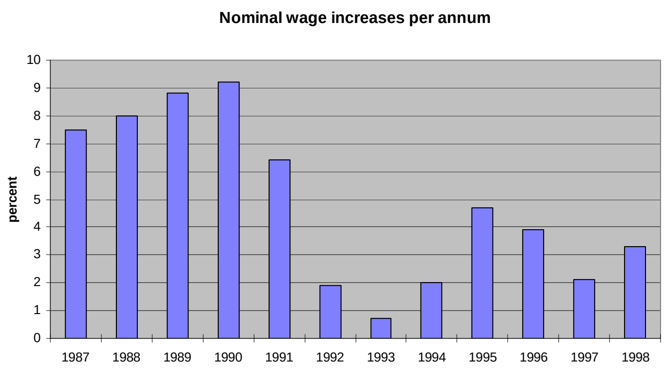
Unemployment rate climbed from 3 to 18 percent within four years (total unemployment was even larger...)



Stock market collapsed but recovered quickly – with the help of foreign investors



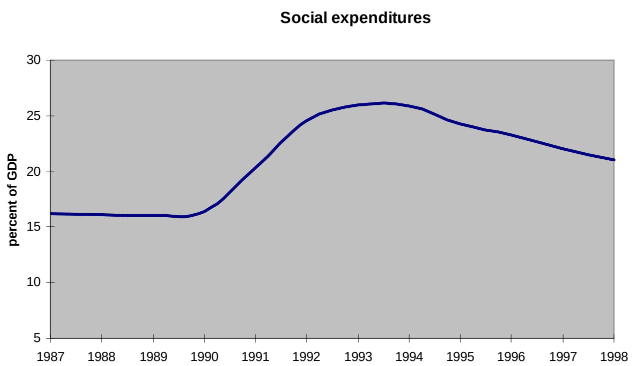
Wage moderation



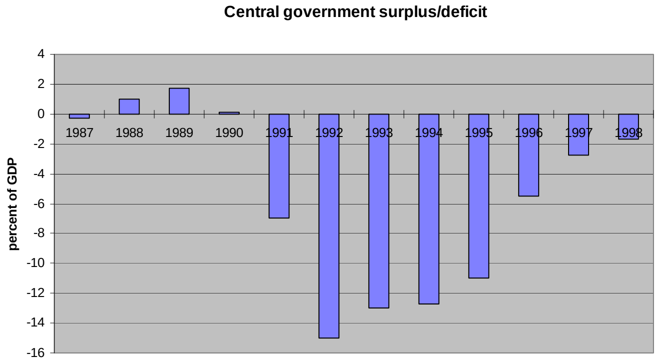
Social and economic disaster

- unemployment rose from 3 to 18 percent in 1990-1994
- permanent increases in long-term unemployment and poverty
- wave of bankruptcies, household debt problems
- public debt increased from 12 to 60 percent of GDP in 1990-1995
- cumulative credit losses of Finnish banks amounted to 15 percent of GDP

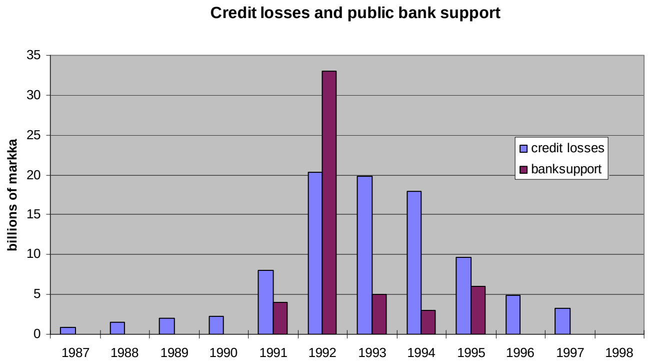
Sharp rise in social expenditures as a result of mass unemployment



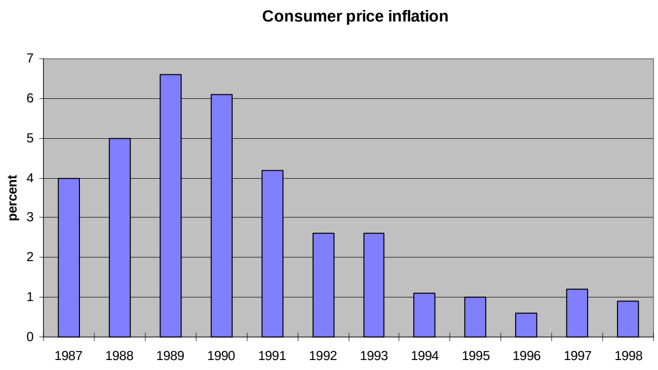
Central government finances got a serious hit



Credit losses were covered by public bank support



Disinflation in spite of 30 percent currency depreciation



THE ROLE OF ECONOMIC POLICY

- Dogmatic reliance on fixed exchane rate policy against market sentiment and fundamentals
- Deflationary policy seen as the only viable option: high interest rates, shrinking aggregate demand – proposals to monetary/fiscal stimulus were rejected by g'ment & CB
- Decision makers: crime & punishment theory of crisis (cf. with the 1930s!)
- The consequences of such policies (=debt deflation) were not understood by policy makers, and they were surprised by the deepness of the crisis

FISCAL POLICY

- Fiscal policy was tightened in 1992-95
- Public demand (and employment) was reduced by 10 percent in 1992-93
- Social benefits were frozen or reduced
- Labour taxes were raised in 1992-95 by 8 % points (both income taxes and employers' contributions): as a result, the real after-tax incomes were reduced sharply
- In spite of these measures there were large deficits in 1992-94
- Fiscal policy was mostly pro-cyclical: tax cuts before and after the recession, tightening during the recession

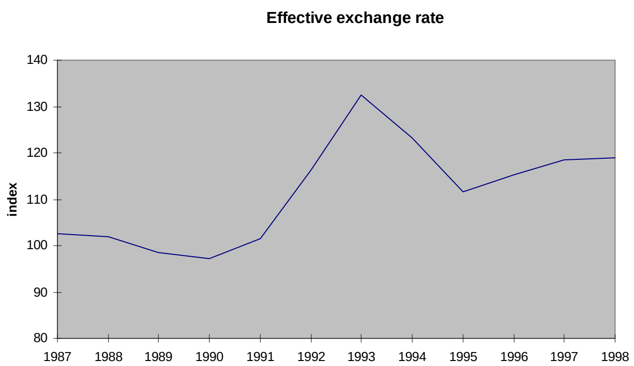
WHY THE DEPRESSION WAS SO DEEP ?

- Main reasons to the crisis were high interest rates caused by international factors and domestic monetary policy, and overindebtedness of Finnish corporate sector
- The macroeconomic consequences of falling asset prices were not understood properly by the policy makers: wealth effect and credit losses came as surprises
- Government's attempts to balance its budget by higher taxes and expenditure cuts backfired by further reducing private demand and employment

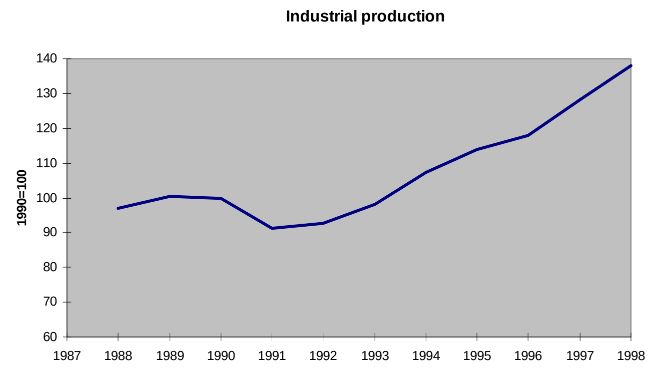
THE WAY OUT OF CRISIS

- The Bank of Finland was forced to abandon the policy of fixed exchange rate in September 1992 during the European currency crisis after losing its currency reserves and the Finnish markka was allowed to float
- the Finnish markka first depreciated by 40 percent, but started to appreciate later
- domestic interest rates were decreased rapidly from 15 to 5 percent

Currency depreciation was partly temporary and partly permanent



Industrial production benefited from devaluation and recovered rapidly



BANKING CRISIS

- Recession produced bankruptcies and credit losses, mostly from construction sector
- Largest losses in savings bank group, which had grown fastest and had highest appetite for risk (bad foreign investments financed by short term foreign currency borrowing)
- Other banks faced serious problems, too

SOLVING THE BANKING CRISIS

- Government take-over of the savings bank group:
  - dissolution and packaging of problem loans to a separate liquidation company (”Arsenal”)
  - final cost 6 billion euros (7 % of 1994 GDP)
  - prosecution of failed bank managers: huge claims, long trials, few convictions
- Healthy parts of savings bank sold to other banks (=hidden subsidy?)
- Government’s equity loans to all banks to recapitalize them

SOLVING THE BANKING CRISIS

- Restructuring and downsizing the banking industry:
  - Merger of two largest commercial banks (KOP + SYP = Merita)
  - Merger of biggest bank with a Swedish bank (Merita + Nordbanken = Nordea)
  - One third of bank staff laid off
- Banking crisis could have been insolvable without lower interest rates (=change in monetary policy); another year of recession would have exploded the credit losses
- Saving the banks was a policy priority, helping their customers was not discussed

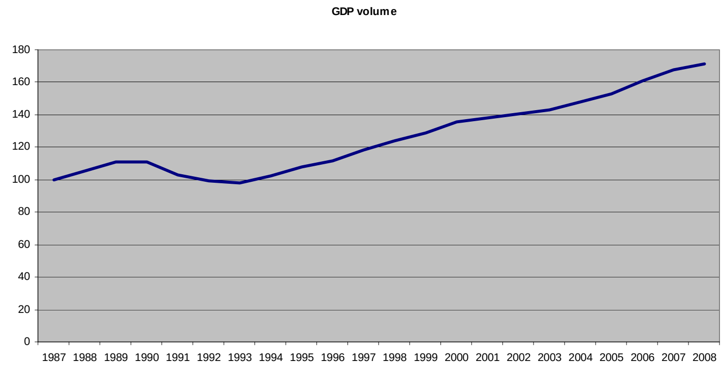
EXPORT GROWTH AND REFLATION

- Depreciation of the Finnish markka, productivity shift ('creative destruction') and wage moderation improved competitiveness hugely in 1992-94
- Strong growth of exports and industrial production started in 1992/1993 – but domestic demand lagged long behind
- Lower interest rates enabled lower savings and asset price reflation after 1994
- Consumer spending started to increase in 1994
- Investment ratio did not recover back to the pre-crisis level (= 25 % of GDP)
- Stock market revival: the HEX-index quadruppled in 1993-1998, dwarfing the pre-crisis 'bubble'

Very strong macroeconomic development after the crisis

- the average annual growth of GDP 4.7 percent in 1994-2000, 3.5 percent in 2001-2007
- unemployment decreased from 18 to 10 percent in 1994-2000 and to 6 percent in 2008
- fiscal consolidation and fulfilment of the EMU-criteria in 1997, record surpluses in 2000 and 2007: at the same time, tax cuts and steady growth of expenditures (=pro-cyclical policy fuelled the recovery)
- despite of significant currency depreciation inflation did not exceed European average (=unemployment above NAIRU)

GDP growth recovered to old trend



The social costs of the crisis were large and durable, and mostly related to long-term unemployment

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REFLECTIONS ON THE CURRENT CRISIS

- Regular financial crises;necessary consequence of unregulated capital movements?
  - Finland & Sweden 1991-93
  - East Asian countries 1997-98
  - Mexico & Argentina
  - Great Crash of 2008
- Similar pattern of crises:
  - Deregulation -> optimism -> credit expansion -> overindebtedness & overvaluation -> panic -> depression
  - Fixed exchange rate has made foreign debt seemingly riskfree

REFLECTIONS ON THE CURRENT CRISIS

- In earlier cases the crises have been solved by currency depreciation
  - Export growth has solved the balance-of-payments problems
- What can be done within the Euro zone?
  - Deflationary policy looks like the only viable alternative
  - But adjustment is slow and painful

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