Economic historians have long noted a high correlation between financial crises and downturns in economic activity. One of the more widely discussed cases during the past two decades is the Nordic banking crisis. During the early 1990s, Norway, Finland, and Sweden all experienced severe banking difficulties. Although events in each country differ, there was a common “two stage” sequence in each country: rapidly increasing economic growth accompanied by financial liberalization and the introduction of new financial instruments, followed by sharp recession and financial crisis. In Norway, loan losses were 0.7 percent of total loans in 1987 and increased to 6 percent in 1991; in Finland, loan losses were 0.5 percent in 1989 and increased to 4.7 percent in 1992; in Sweden, losses were 0.3 percent in 1989 and increased to 7 percent in 1992. Widespread losses affected the residential and commercial real estate, retail, and service sectors, among others. Some losses were exacerbated by foreign currency exposure.

Honkapohja (2009) cites deregulation of the financial system in the 1980s as the root of both the economic downturn and the financial crisis. Around 1980, attractive interest rates amplified inflows of capital; in these deregulated markets, credit expanded according to market forces. Honkapohja notes that this “led to uncontrolled credit expansion” and “soaring indebtedness in the private sector” and furthermore that the rules and practices of 1969 were left unchanged when banking was deregulated and financial instruments evolved. The result was an increase in information asymmetry—the now all-too-familiar historical precursor to financial crises—amplified by international capital inflows. If international investors enter a country with complete information, and if their confidence in the country does not change, then that country’s economy may be able to function well with a relatively high level of international debt. However, if investors enter a country with imperfect information, or if the rate of growth changes, they may seek to withdraw capital. Honkapohja cites Denmark in counterpoint: The essential feature of Denmark was a much smaller level of asymmetric information: “Prudential supervision, disclosure rules, and capital adequacy requirements for Danish banks were made stricter than the other Nordic banks.”

Honkapohja offers some recommendations, based on the Nordic experience, for policy responses to financial crises:

1. First, build a bipartisan political consensus to support the actions needed to maintain confidence in the banking system. This includes establishing a new crisis resolution agency to handle both communication with the public and bank restructuring. If successful, such an agency can reduce conflicts of interest or “turf fights” among existing agencies while providing capital and liquidity to banks, even if another agency (such as the central bank) provides funding. This agency may also be well placed to moderate inevitable attempts by bank owners to capture for themselves a greater share of the largesse—actions that can undermine public support for crisis resolution. Second, seek private solutions, including mergers and acquisitions; avoid liquidations when possible. Third, be very transparent regarding support actions. In the Nordic case, public confidence was sustained and bank runs avoided (absent government deposit insurance) through a highly visible public government guarantee for the obligations of banks, including both deposits and borrowings. While debt holders were protected, equity holders suffered decreases in value but were not automatically wiped out when the governments provided support. An additional element of the Nordic resolution was openness, “refraining from concealing both the extent and nature of the problem.” This required openly accounting for all expected losses and write-downs, for all banks, at an early stage. For many assets, especially real estate, this is a difficult problem; Ingves and Lind (1996) note that in Sweden this was successfully solved with adjusted asset values subsequently earning a return “close to the market.
rate.” They also emphasize the “unpleasant truth” about banking crisis resolutions that there will be losses and that the “loss has to be covered—in one way or another.” Besides guiding public assistance, honest accounting may instill confidence in private investors who perhaps will recapitalize potentially viable banks. Of the six large banks in Sweden, for example, three received public assistance and three did not; the latter were able to raise necessary capital privately.7 Society-wide benefits also might accrue if the fire-sale disposal of assets can be avoided and public confidence in the financial system can be sustained.8

The Nordic bank resolution is widely regarded as among the most successful in history. In all three countries, the final net cost of assistance to the banks (net of liquidation of assets and including appreciation in the value of government shares) was far smaller than the initial cost—for Sweden and Norway, near zero, for Finland, an eventual 5.3 percent of 1997 GDP versus initial outlays of 9 percent of GDP.9

References


1 This pattern is the classic historical experience, perhaps observed first in Britain in 1825 (Neal, 1998). For the U.S. experience since 1857, see Mishkin (1991).

2 These figures are from Drees and Pazarbaşioğlu (1998).

3 While noting the correlation between deregulation and the crisis, Drees and Pazarbaşioğlu (1998) place more weight on deteriorating macroeconomic conditions, declines in income (particularly oil, in the case of Norway, but also in the terms of trade for commodity exporters such as Sweden), and depressed asset markets.

4 The Nordic countries did not invent these solutions; their actions were modeled, in a large part, on the U.S. Resolution Trust Corporation (RTC). Generally, Honkapohja’s points are discussed in all the references listed below.

5 This type of ex post government deposit insurance has become almost an expected feature of banking crises. The British government expanded its limited deposit insurance to deposits in full after the runs on Northern Rock (see Mizen, 2008); in the United States, the FDIC recently increased its deposit insurance limit, temporarily, to $250,000 on most accounts and added unlimited insurance for non-interest-bearing transaction deposits (used primarily by businesses).


8 See Ingves and Lind’s (1996) superior discussion of the social and political trade-offs inherent in any bank support actions.

9 See Table 2 in Honkapohja (2008), which he cites from Sandal (2004).