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Resolving a Banking Crisis, the Nordic Way

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 details 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. 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. During the 1980s, attractive interest rates in the Nordic attracted capital inflows; in their then-recently deregulated markets, credit expanded in response to market forces. Unfortunately, rules and practices governing safe and prudential banking had not been updated when banking was deregulated; rather, the rules of the 1960s, adopted during a period of tight regulation, continued. 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 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: 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 debt securities. 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 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—the new lower adjusted asset values subsequently earned a rate of 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. 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. 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.

—Richard G. Anderson

Honkapohja, Seppo. "The 1990's Financial Crises in Nordic Countries." Bank of Finland Research Discussion Papers No. 5, 2009.

Ingves, Stefan and Lind, Göran. "The Management of the Bank Crisis—in Retrospect." *Sveriges Riksbank Quarterly Review*, 1996, (1), pp. 5-18.