The 1990's Financial Crises in Nordic Countries

Seppo Honkapohja,
Bank of Finland

I. Introduction

- 19 crises in advanced countries since WWII (before the current)
- 1990’s crises in Finland, Norway and Sweden are among the ”big five”
- In 1990-93 bank loss provisions (of lending):

  2.9 % in Denmark,

  3.4 % in Finland,

  2.7 % in Norway

  4.8 % in Sweden

- All Nordic countries provided public support to their banks
- Crises in Finland, Norway, and Sweden became systemic
- Crisis remained non-systemic in Denmark

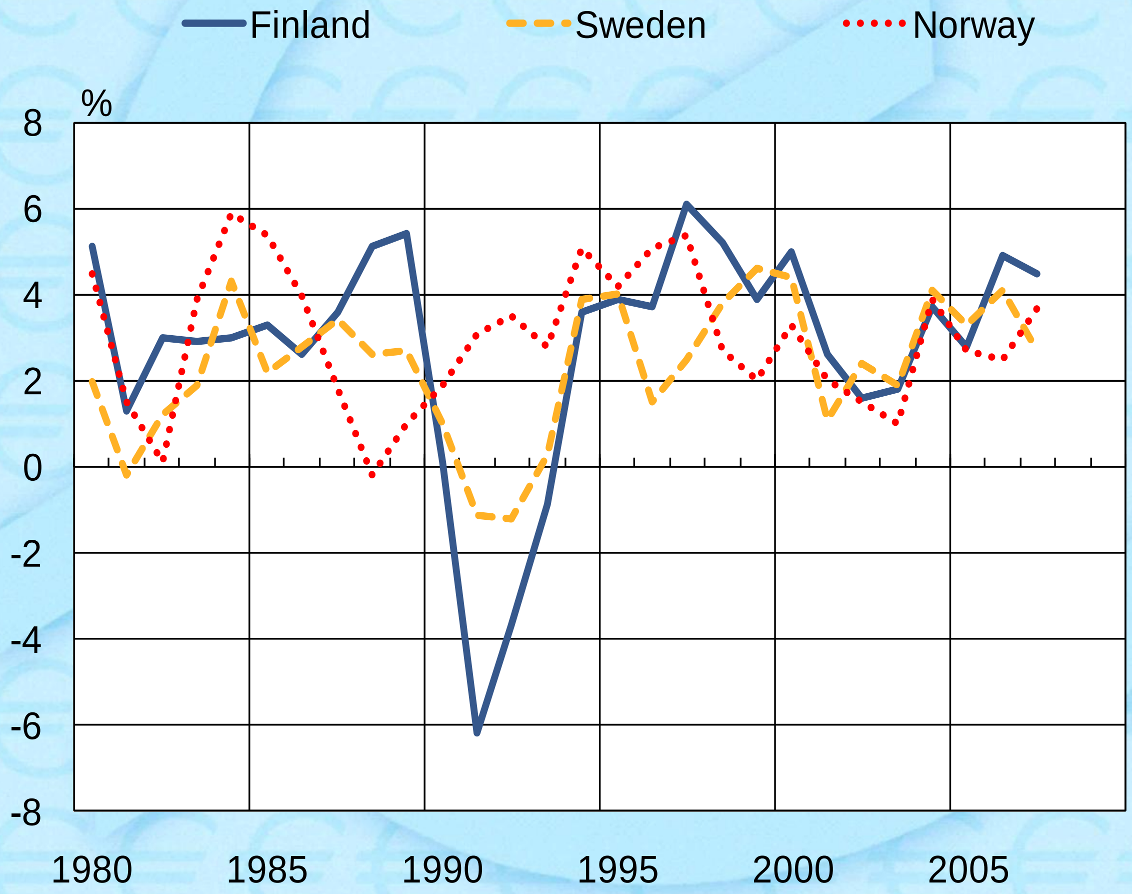
Outline of Talk

- Main developments
- Reasons for the crises
- Crisis management
- Lessons

- My perspective

II. Main Developments
II.1 The Real Economies

Figure 1. Real GDP growth



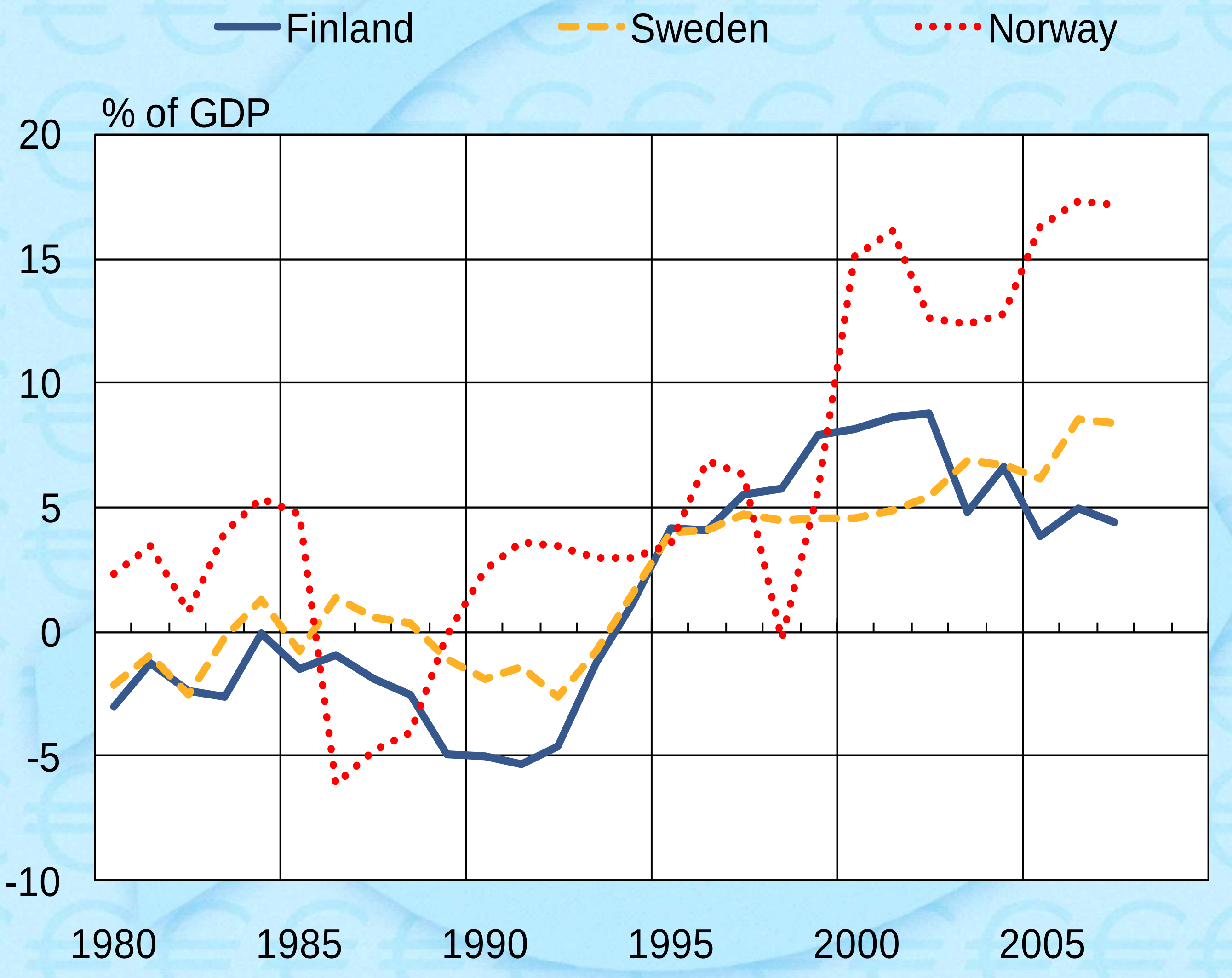
Sources: Eurostat and IMF.

Finland and Sweden

- Overheating in 2nd half of 1980's
- Recession with negative growth in early 1990's
- Recovery, then good performance
- Note: Finnish developments more extreme

- Norway had an earlier upswing, recession in 1987, but no (significant) negative growth
- Fairly slow recovery, then good performance

Figure 2. Current account



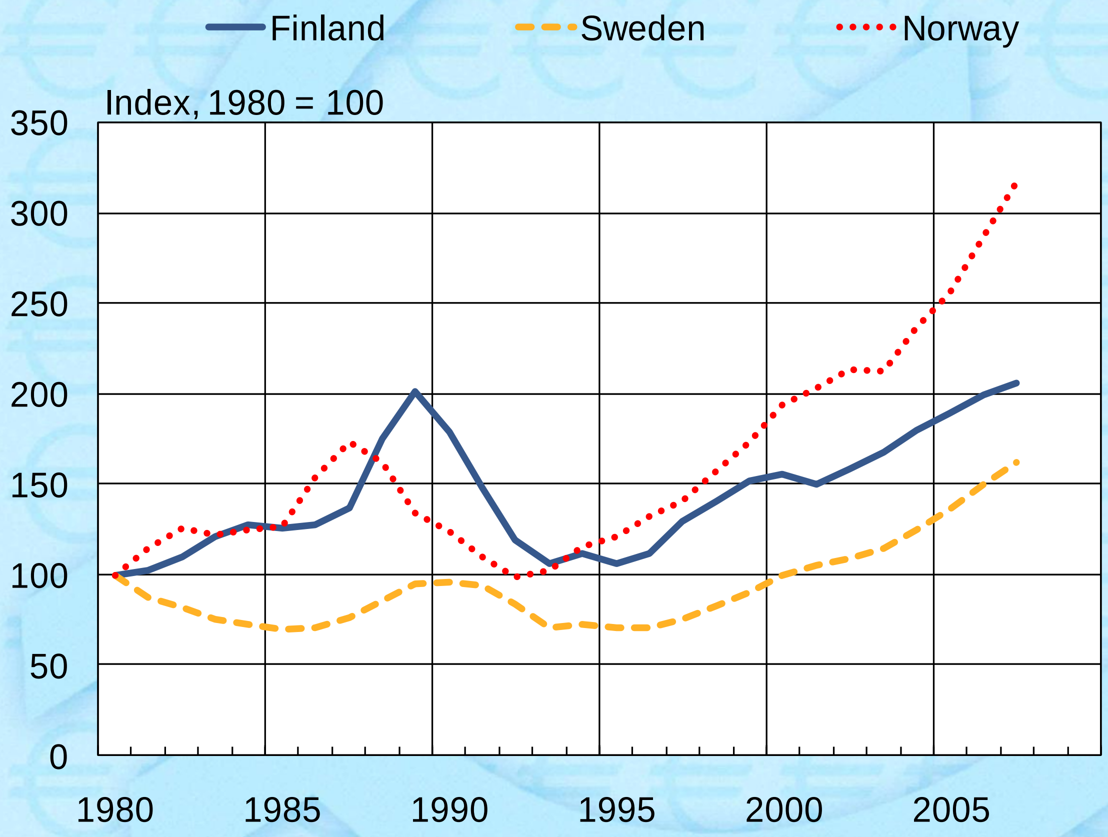
Source: European Commission.

Current account

- Finland had major CA deficits in 1980s and early 1990s
- Smaller but fairly persistent CA deficits for Sweden
- Norway had CA surpluses, except in 2nd half of 1980s after decline of oil prices in 1986

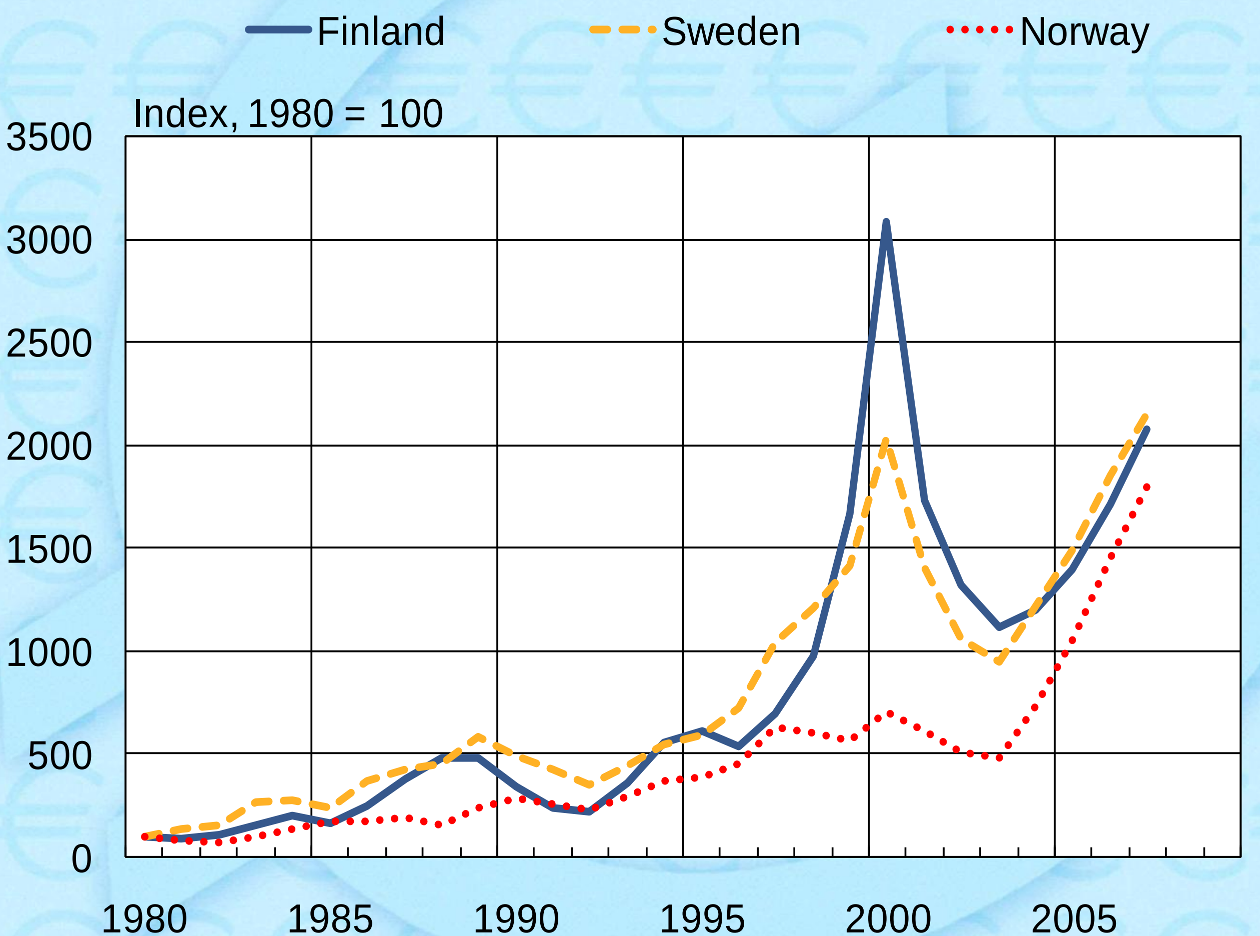
II.2 Financial developments

Figure 4. Real house prices



Nominal house prices deflated using the consumer price index.
Sources: Statistics Finland, Statistics Sweden, Norges Bank and Bank of Finland.

Figure 5. Real share prices



Nominal share prices deflated using the consumer price index.
Source: IMF.

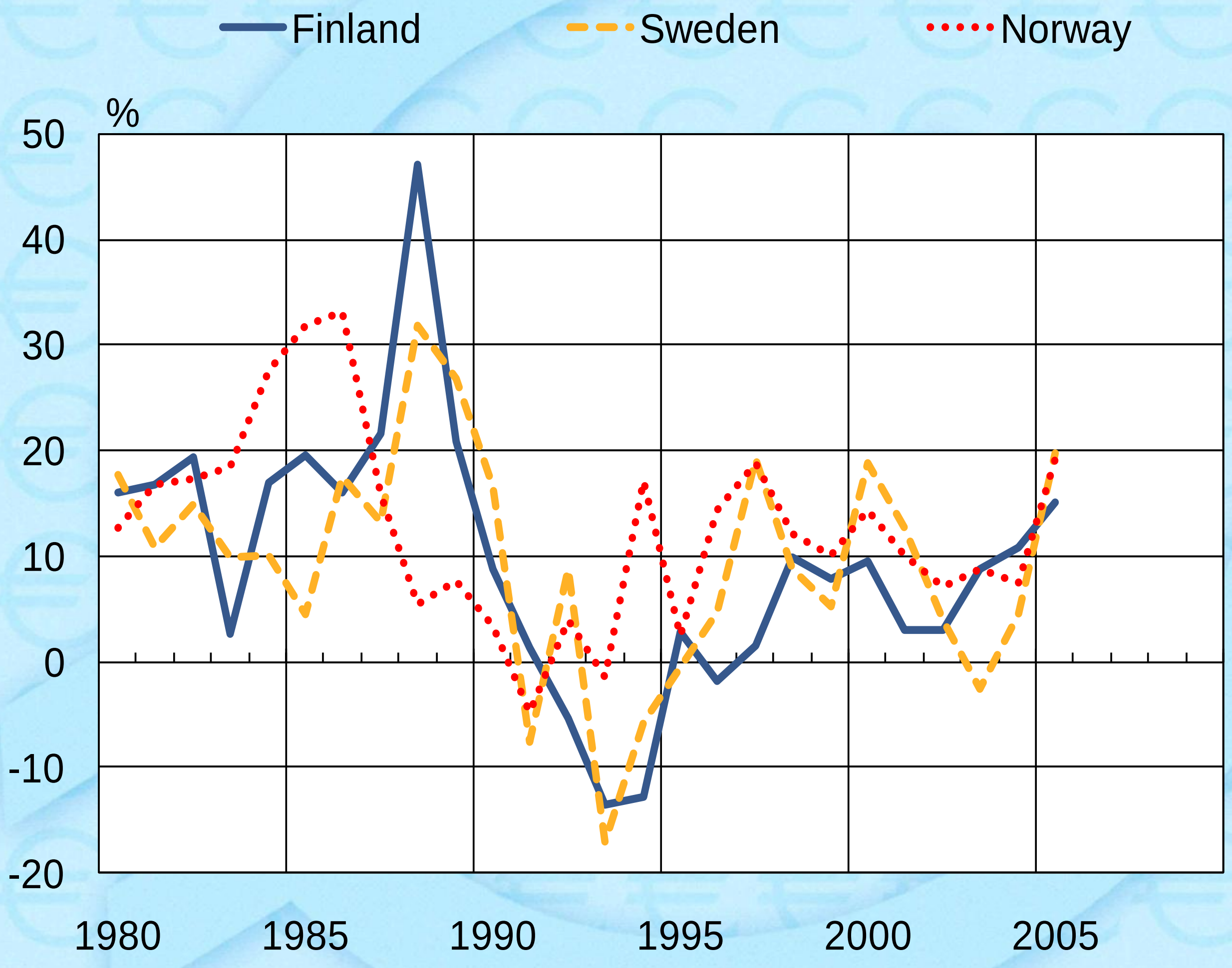
House prices

- Strong boom and subsequent decline in Finland and Norway
- Long decline in Norway
- less pronounced and slow movements in Sweden

Stock prices

- Strong movements in Finland and Sweden in late 80's and early 90's
- Little movement in Norway during the boom and crisis

Figure 6. Lending growth



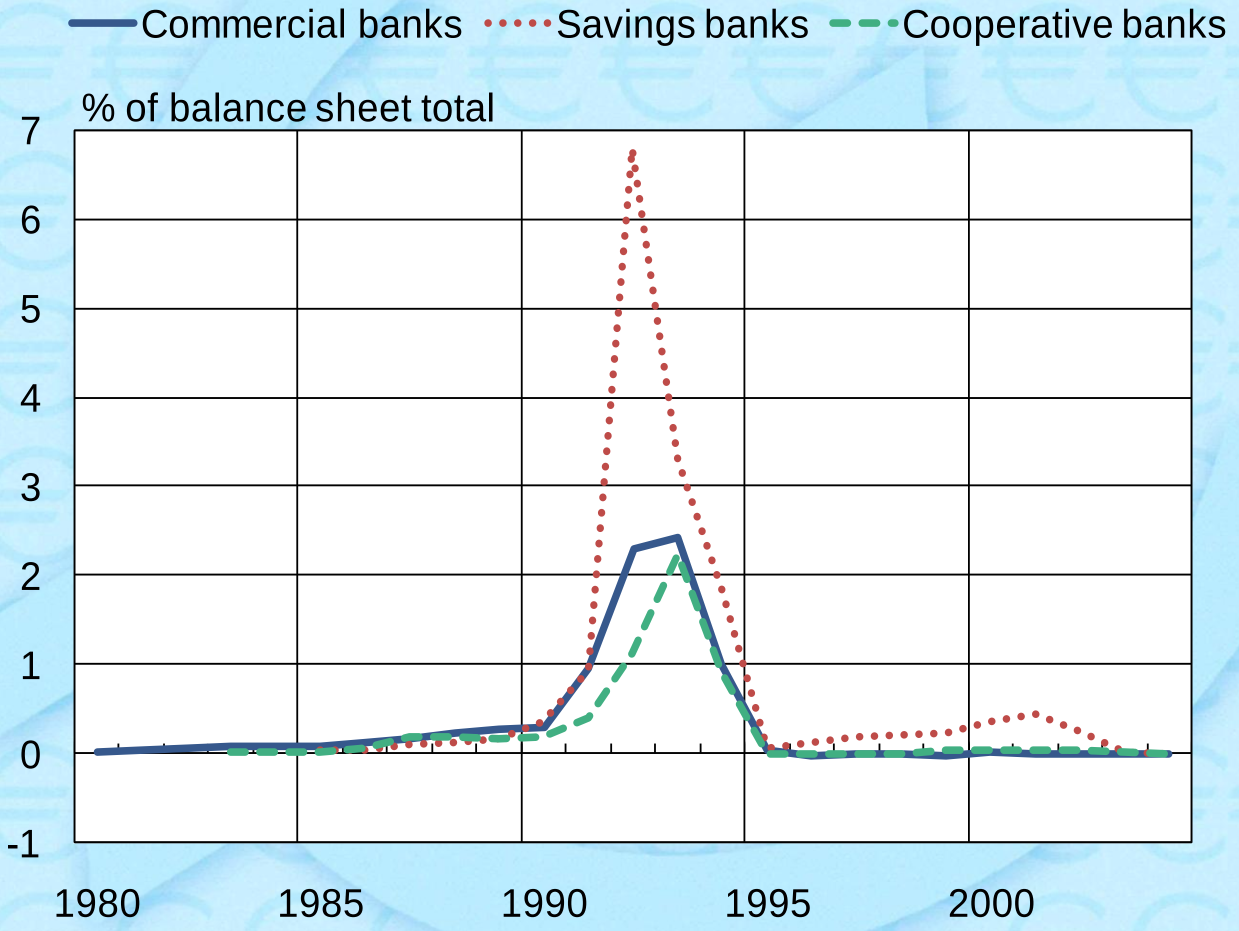
Sources: OECD and Bank of Finland.

Bank lending

(percent of GDP)

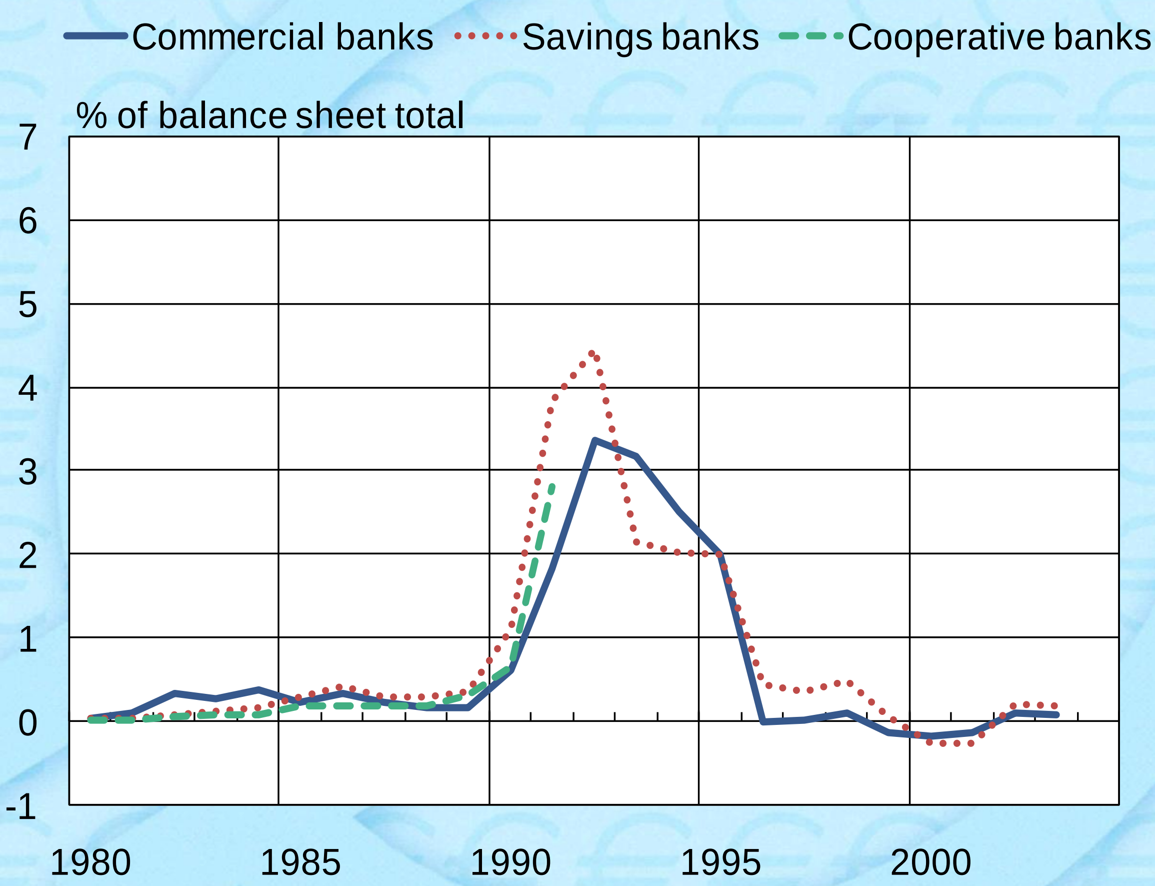
- ♦ Strong increase during the 80's boom
- ♦ Major decline with the onset of the recession
- ♦ Finland and Sweden had negative lending growth for 2-3 years in early 90's

Figure 7. Loan loss provisions in Finland



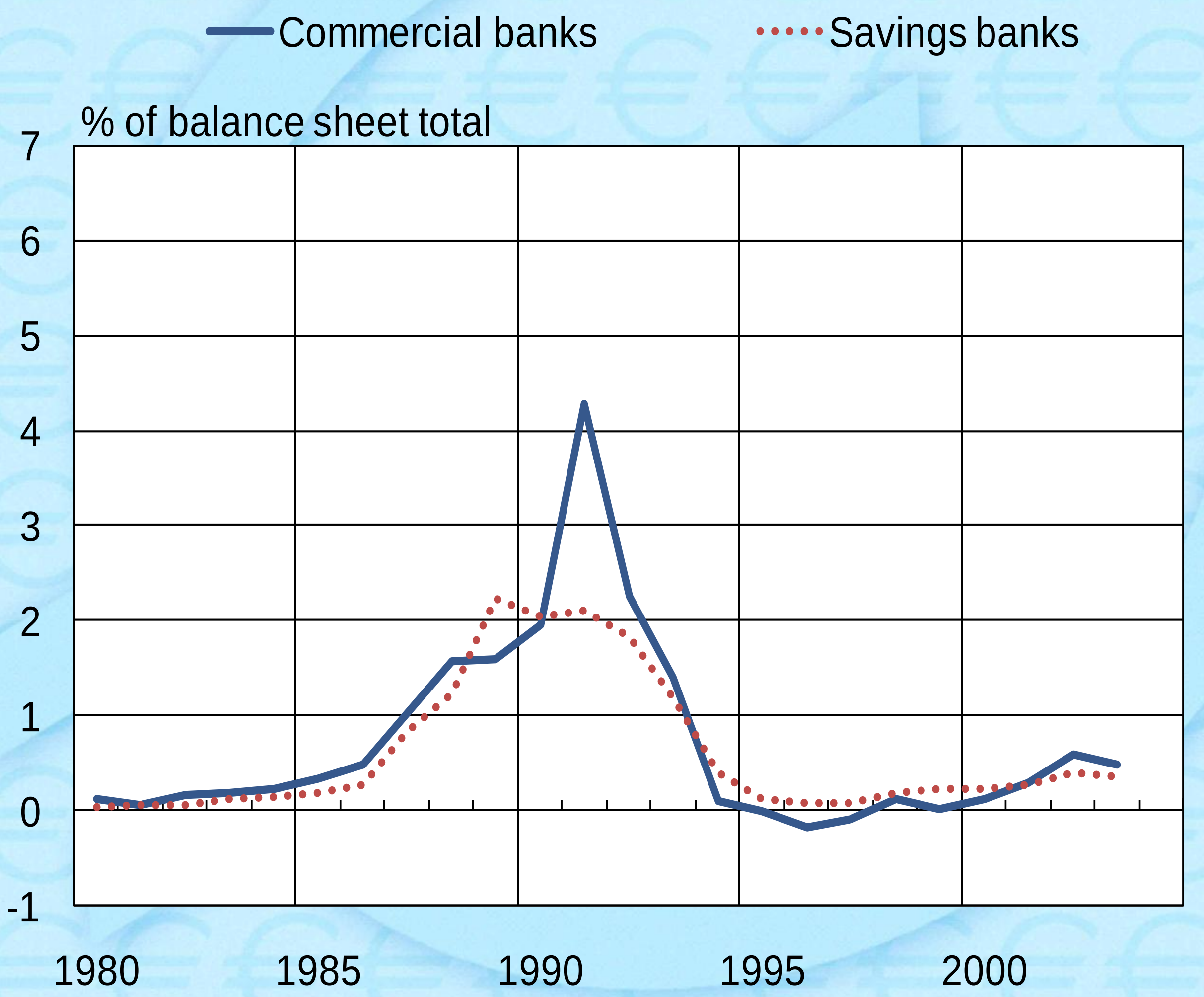
Sources: Drees and Pazarbasioglu (1998) and OECD.

Figure 8. Loan loss provisions in Sweden



Sources: Drees and Pazarbasioglu (1998) and OECD.

Figure 9. Loan loss provisions in Norway



Sources: Drees and Pazarbasioglu (1998) and OECD.

III. Reasons for the Crises

♦ Focus on Finland (deepest crisis)

III. 1 Boom

- Finnish boom caused by
  - financial market deregulation (with problematic elements)
  - Freeing of capital movements, with attempt to tight monetary policy under fixed exchange rate
  - Upswing in western economies (bad timing)
- Swedish boom similar, but milder
- Norway: boom cut short by oil price decline in 1986

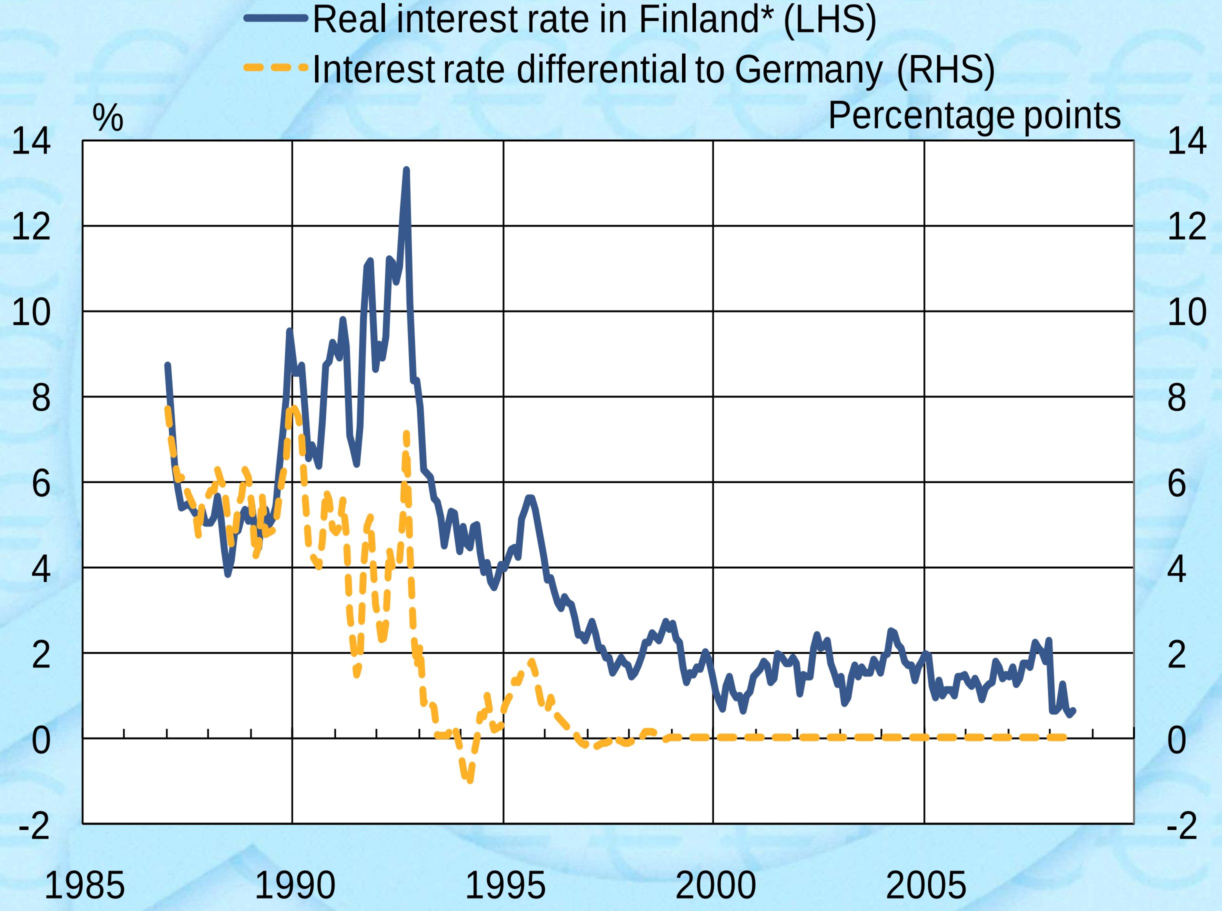
III. 2 Bust

- Negative international shocks
  - slow growth in the west
  - collapse of Soviet Union -> huge decline in trade with Russians
  - German unification led to high real interest rates

    (Figures)
- Domestic policy
  - Domestic monetary policy very restrictive because of defence of fixed exchange rate

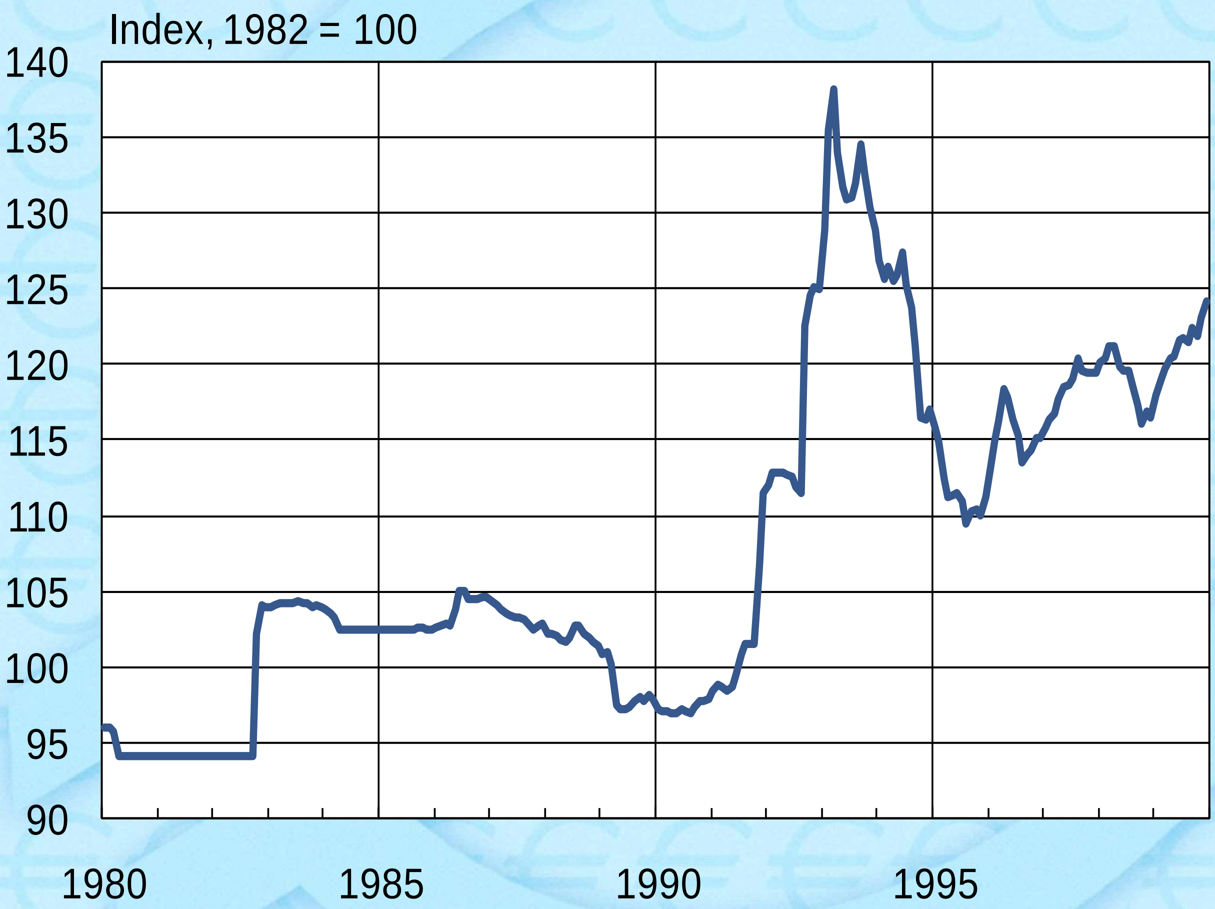
- Finland started to recover in 1993-94

Figure 10. Real interest rate in Finland and interest rate differential to Germany (3-month rates)



* Nominal interest rate - consumer price inflation.
Sources: Reuters and Bank of Finland.

Figure 11. Bank of Finland currency index



Trade-weighted currency index. Rising curve indicates FIM depreciation.
Source: Bank of Finland.

- The recession was largely similar but smaller in Sweden, except Sweden had no trade with Soviet Union
- Swedish industry was also more modernized than Finnish industry
- Norway: recession in 1987-88 because of oil price decline and restrictive policies; only slow recovery

III. Reasons for the Crisis

- Problems in financial deregulation
  - bad timing with international business cycle upswing
  - Bank laws and bank supervision were outdated (tightening only in 1991)
  - Tax system favored debt financing
  - Lending rates freed before deposit rates
  - fixed exchange rate system
- International dimension for Finnish and Swedish crises

  => ”twin crises”

IV. Crisis management

- **Finland**
  - 1st measure: Bank of Finland took control of Skopbank in September 1991
  - Public support: preferred capital certificates to banks, with strict requirements
  - Government set up the crisis management agency
  - Policy-makers made promises to guarantee banks’ obligations, also further public support
  - Support to be converted into shares if not repaid

- Finland (continued)
  - Banks became profitable again in 1996
  - Improved efficiency (staff halved, etc.)
  - Major restructuring of banking system:
    - savings banks largely disappeared,
    - one big commercial bank was merged to another
  - Nowadays 60 percent of banks owned by foreigners

=> Biggest part of the crisis was in Savings Banks

- **Sweden**
  - Crisis erupted in autumn 1991 with Första Sparbanken; government gave a loan and FS merged with other savings banks
  - Nordbanken (3rd largest comm. bank) was 71% govt owned and had to be recapitalized
  - Many banks made heavy credit losses
  - In autumn 1992 blanket creditor guarantee by government
  - Crisis resolution agency set up, public support with strict criteria in risk reduction and efficiency

- Sweden (continued)
  - Some banks did not need public support

⇒ In the end nearly all support went into two banks, Gotabanken and Nordeabank.

- Nordeabank became a pan-Nordic bank ”Nordea”

- **Norway**
  - Crisis erupted in autumn 1988
  - Initially private guarantee funds provided support and bank mergers took place
  - In late 1990 private funds were exhausted, so government guarantee funds set up in early 1991
  - Support had to be converted into solvency support
  - In autumn 1991 capital support needed
  - In Spring 1992 several banks, incl. three biggest commercial banks were nationalized

- Norway (continued):
  - no blanket guarantee by government, but specific announcements about securing depositors and creditors
  - Banks situation started to improved in 1993
  - One of nationalized banks was sold in 1995 and two other banks were sold later
  - Government still owns 34 percent of one bank

=> In the end the Norwegian tax payer made money out of the crisis (not so in Finland and Sweden)

	Gross cost	Net cost
Finland	9.0 (% of 1997 GDP)	5.3 (% of 1997 GDP)
Norway	2.0 (% of 1997 GDP), 3.4 (present value , % of 2001 GDP)	-0.4 (present value, % of 2001 GDP)
Sweden	3.6 (% of 1997 GDP)	0.2 (% of 1997 GDP)

V. Lessons

- **Prevention of major crisis** is first priority; stability-oriented macro policies
- How to diagnose an overheating situation?
  - rapid credit expansion
  - strong increase in leverage
  - big external deficits in open economies
- Political-economy reasons can be a major obstacle in prevention

- **Crisis management**
  - Maintaining confidence in banking system is crucial
  - Broad political support; political guarantees to banks’ obligations in Finland and Sweden but not in Norway
- Role of central banks
  - Liquidity support in Norway and Sweden
  - Bank of Finland had to take over a problem bank

- Crisis resolution agencies in all three countries
  - Administrative separation from central bank and ministry of finance
  - Capital injections to banks
  - Guiding of restructuring of the banking system
  - Treatment of ”old shareholders” was mixed
- Asset management companies (”bad banks”) to deal with non-performing assets
  - Norway: banks had their own bad banks
  - Finland and Sweden had public agencies

=> Nordic practices in crisis resolution have been praised afterwards.