Financial liberalization in Western Europe: lessons for China?*

Seppo Honkapohja
Bank of Finland

* Views expressed are my own and do not reflect possible views of the Bank of Finland

Outline

I. The European situation after WWII
- External dimensions

II. Liberalization of banking and financial systems

III. Close look at the Nordic countries

IV. Issues raised by Nordic liberalizations

V. Lessons for China?
- The financial system of China, main features
- 1980s Nordics and present-day China compared
- Lessons?
- Lessons from the Euro era

I. The aftermath of WWII

- Financial instabilities in 1930’s and destruction from the war.
- Main concern: generation of adequate savings to ensure funding for project of reconstruction and industrial development.
  - Often focus on priority sectors such as basic industries, exports and the housing sector.
- Regulatory frameworks to protect financial services industry were kept unchanged.
  - Interest rates were kept stable and below the market levels.
  - Also public debt levels were very high after WWII.

- Views of governments began to change gradually.
  - Some marketable financial instruments were introduced in 1950’s, 60’s and 70’s (treasury bills, certificates of deposit, commercial paper).
  - Interest rate controls were gradually lifted, especially during 1980s. (See table)
    - This led to tightening of interest margins.
  - Time tables differed a lot between countries.
- Other gradual developments
  - Deregulation of financial services (fees).
  - Removal of direct lending controls and investment regulations.
  - Strengthening of competition among financial institutions.
  - Financial assistance (low-rate financing, tax incentives etc.) reformed or removed.

	End–1960	End–1980	End–1987
Australia	X	X	—
Austria	X	X	X
Belgium	X	X	X
Canada	X	—	—
Denmark	X	X	—
Finland	X	X	—
France	X	X	X
Germany	X	—	—
Greece	X	X	X
Ireland	X	X	—
Italy	X	—	—
Japan	X	X	X
Netherlands	X	—	—
New Zealand	X	X	—
Norway	X	X	—
Portugal	X	X	X
Spain	X	X	—
Sweden	X	X	—
Switzerland	X	X	X
Turkey	X	X	X
United Kingdom	X	X	—
United States	X	X	X

X = Official controls or private agreements.
— = No official controls or private agreements.
Source: Annex III, Section I.

Source: OECD

External dimensions

- Exchange controls in some countries in 1930s and majority of countries right after WWII.
- Fixed exchange rates regime, capital controls.
  - Aim to liberalize capital movements.
- Bretton Woods institutions
  - IMF for loan facilities for countries in temporary difficulties.
  - OEEC (later OECD) for trade liberalization.
  - European Payment Union: clearing balances and credit.
- EEC led to liberalization of real economies.
- OECD (in 1961) engaged countries in process of liberalization of Capital Movements.

Further external developments

- Only a few countries did not have permanent exchange controls: Canada, USA, Switzerland, Germany (after 1958).
  - Some reversals in 1960’s and 70s.
- Breakdown of Bretton Woods system in 1971
  - In Europe, creation of the ’Snake’ for exchange rates in 1972
    - EU currencies within a tunnel of 4.5% against USD
    - 9% band for currencies against each other
  - The European Monetary System in 1978
    - ERM: fixed and adjustable exchange rates with mutual support
    - Big inflation differentials => realignments in the first years
    - Few realignments in 1980s.

- 1980's saw renewed efforts to capital account liberalizations.
  - Preparations in the EU: some countries (Germany, UK, Denmark) liberalized before 1986 EU Directive.
    - Netherlands joined at the end of 1986.
  - New EU directive in 1988 with France joining the process.
- Maastricht Treaty in 1992 made free movement of capital one of the cornerstones of EU.
  - EMS crisis in 1992-93 led to realignments, then wide bands for exchange rates.
  - Road to EMU (started in 1999).
    - New ERM for outsiders.
    - Also floaters (Sweden, UK…)

II. Liberalization of banking and financial systems

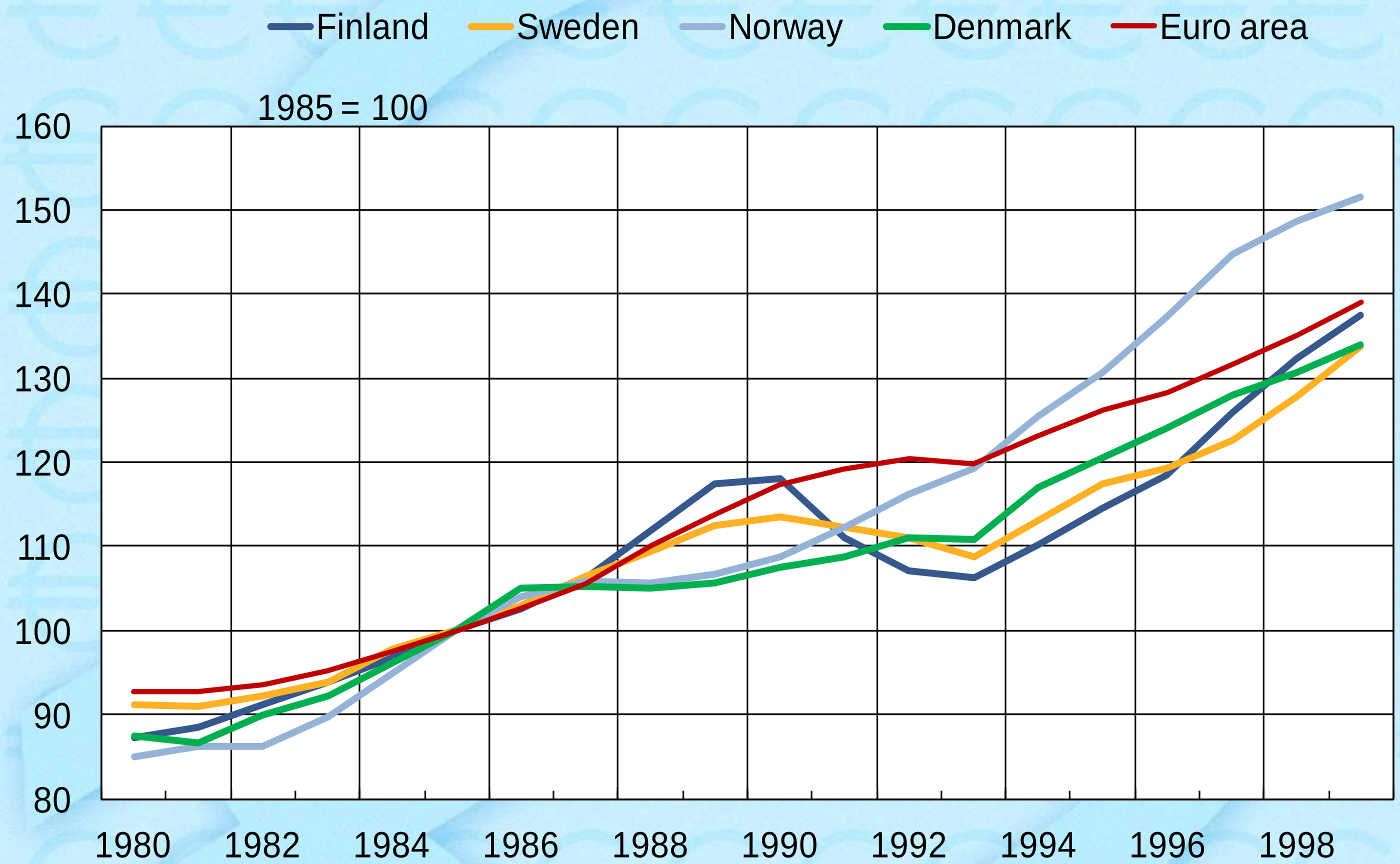
- Timing of domestic liberalization varied among different countries.
- EU legislation, important steps from 1989 onward
  - Single EU banking licence,
  - Single passport for investment services,
  - Single market in financial services etc.
- Banking crises in Europe
  - Problems with individual banks: BCCI, Banesto, Barings, Credit Lyonnaises and various small banks.
  - Systemic banking crises: 3 Nordic countries in early 1990’s and Spain in early 1980’s
    - among the ”big five crises” of advanced market economies before the current crisis

- Rapid change and growth of the financial sector:
  - Expansion due to deregulation and the EU Single Market Program.
    - Banking assets/GDP in big EU countries rose from 175% (in 1984) to 283% (in 2004).
  - Decline in traditional banking (deposits, lending).
- Emergence of Pan-European Banks put strains on the supervisory framework.
  - Supervision relied on national responsibilities.
  - Home country supervision is difficult for small countries that must deal with large banks.
  - Host country principle: practical problems with international banks.
- The current crisis: Banking problems are a part of the global financial crisis.

III. Close look at the Nordic countries

- Why important?
  - Three out of four countries developed very big financial crises from liberalization.
- Background on Nordics:
  - Small open economies, total population over 22 million:
    - Wide-spread ties, e.g., common labor market since 1954
    - Sweden wealthiest in 1970s, Finland weakest (suffered heavily in WWII)
    - Foreign trade and associated payments liberalized early by the end of 1950's
  - Egalitarian, socially cohesive countries with democratic tradition:
    - Big public sector, strong influence on the economy
  - Financial repression was an instrument of growth and industrialization policies.
    - More rapid inflation than in much of the western world.

GDP



Source: Eurostat.

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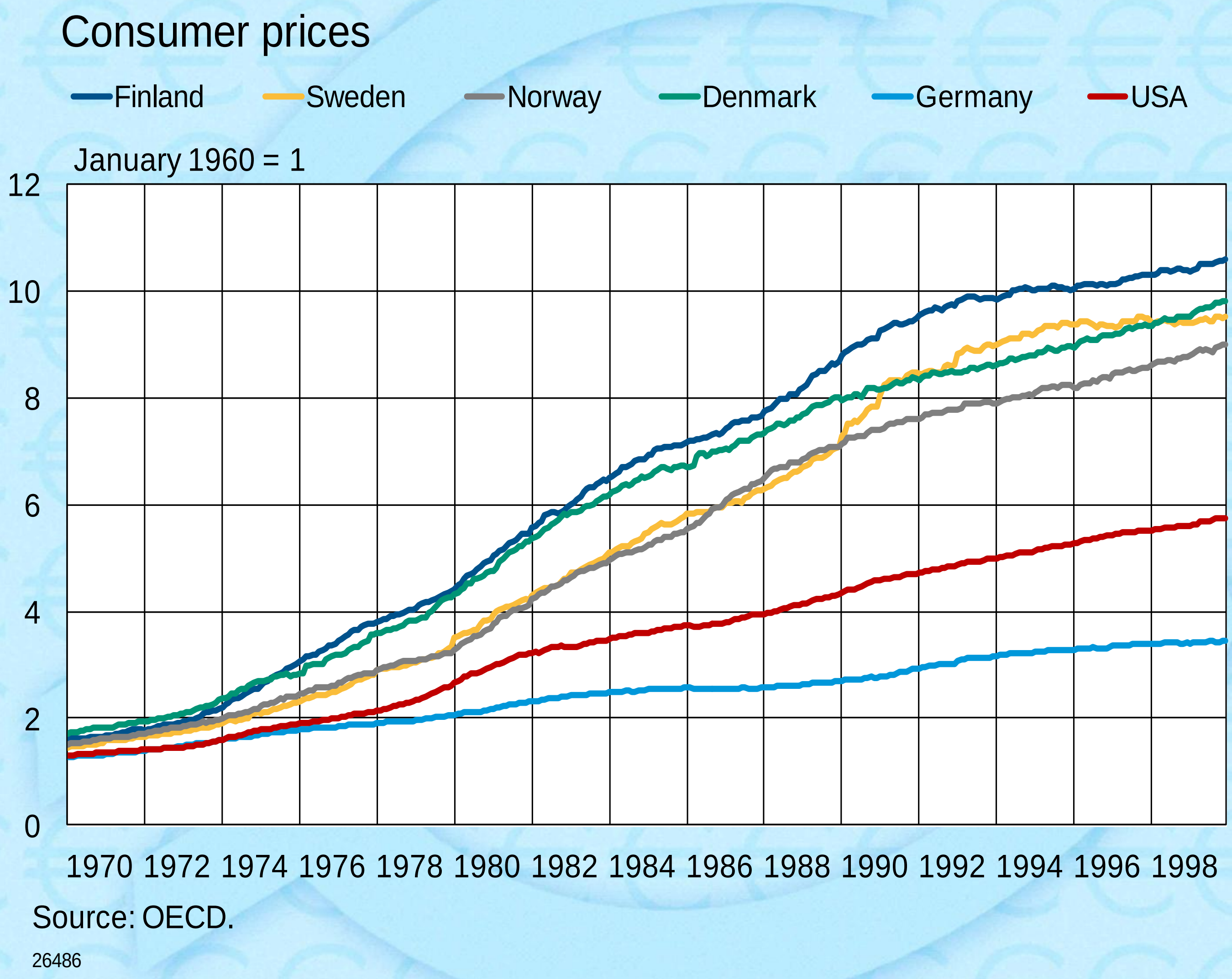
Consumer prices
Finland
Sweden
Norway
Denmark
Germany
USA
January 1960 = 1
12
10
8
6
4
2
0
1970 1972 1974 1976 1978 1980 1982 1984 1986 1988 1990 1992 1994 1996 1998
Source: OECD.
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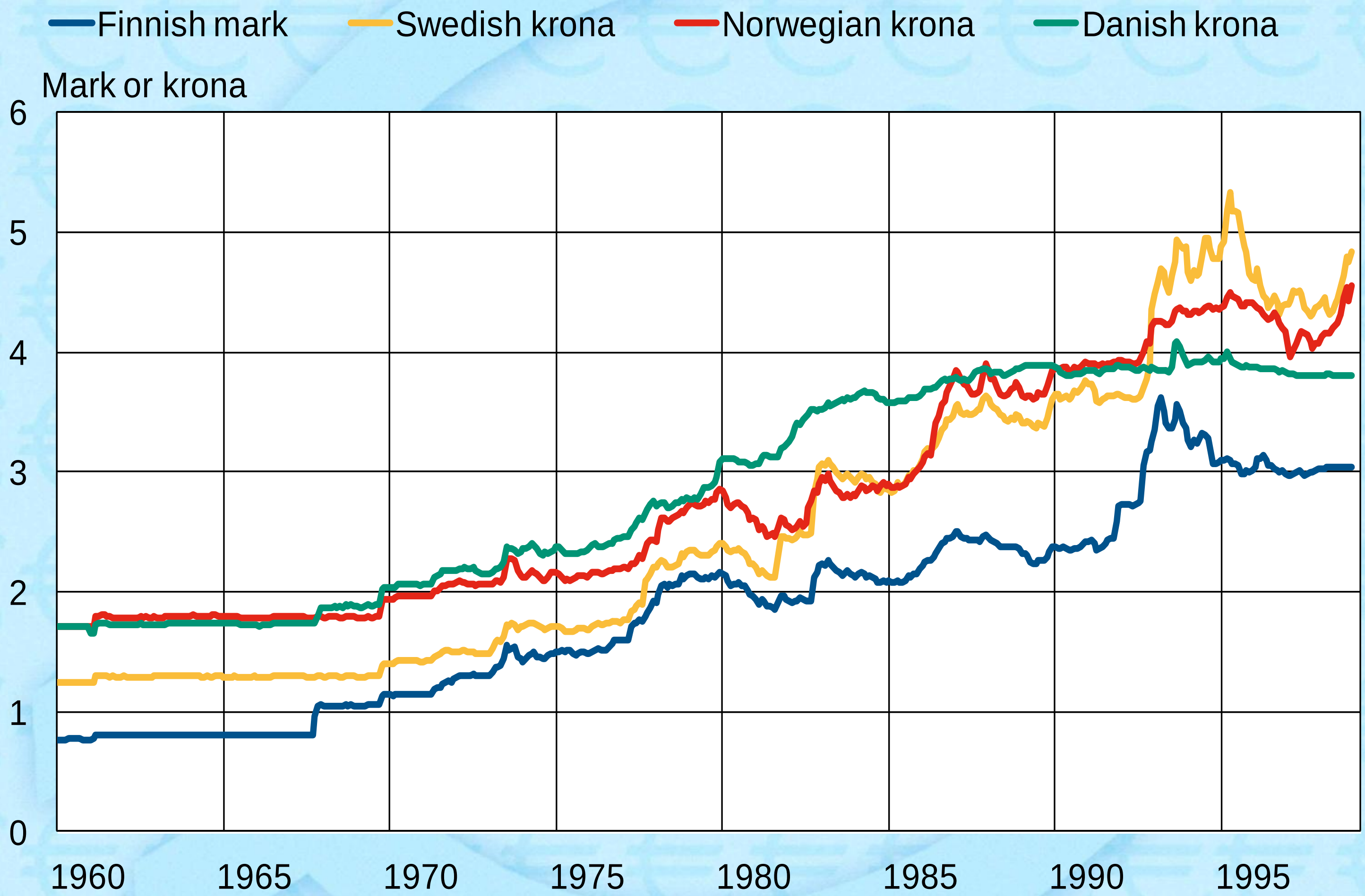
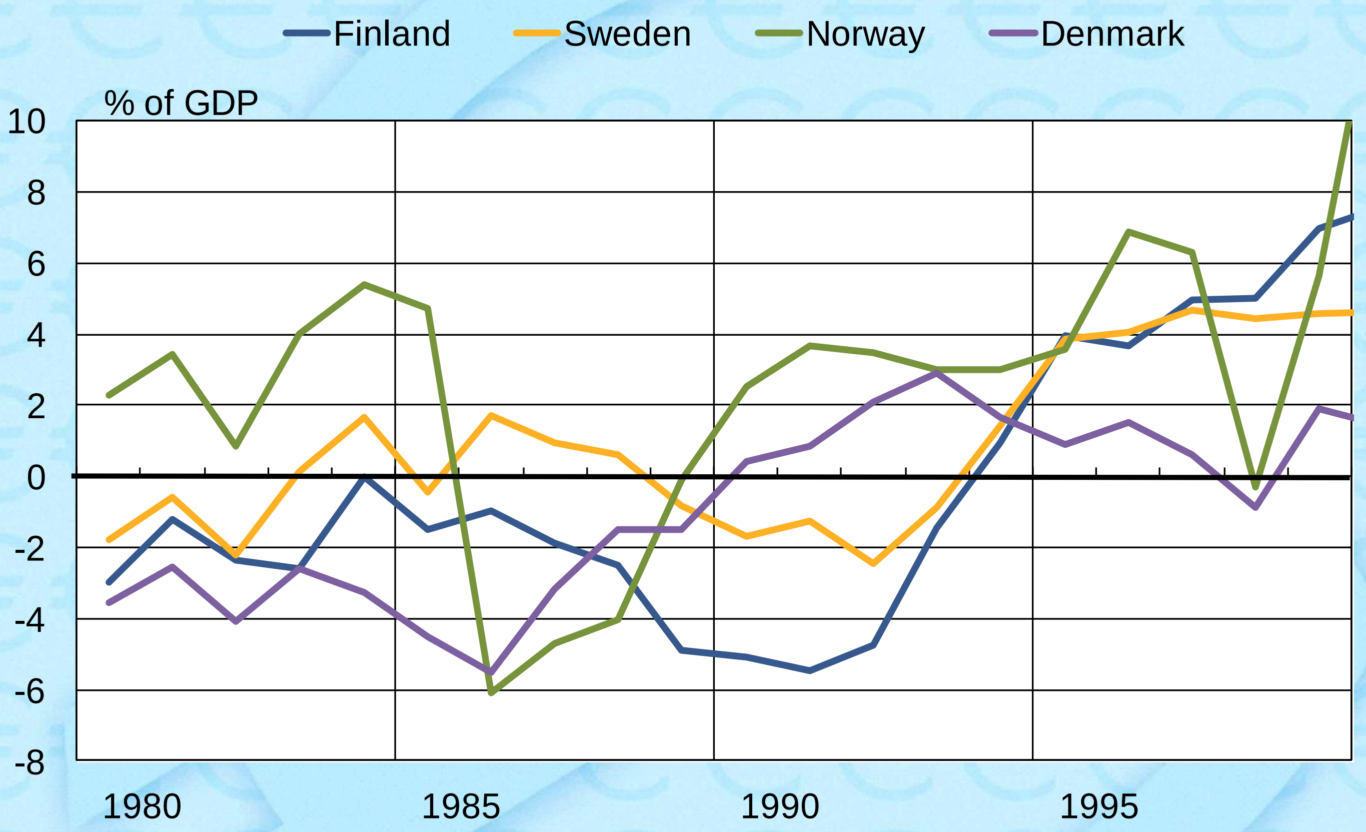
Nordic currencies against German mark



Source: Bank of Finland.

Current account



Source: European Commission.

25125@Chart2_2 (en)

Nordic financial systems in early 1980's

- Denmark had a more liberal system.
  - Details will not be discussed.
- Financial systems were tightly controlled:
  - Interest rate controls by Central bank.
  - Central Bank controlled credit flows in the economy.
- Banking system dominated by a few large banks and many smaller banks.
  - Mostly private ownership of banks,
    - capital largely raised from the private sector
  - Banks rationed credit to households and firms.

- Exchange rates pegged to currency baskets.
- Capital account controls:
  - Permits for long-term movements,
  - no short-term financial movements,
  - Foreign trade finance relatively free,
  - Fx for travel rationed.
- Non-bank systems:
  - Stock, bond markets and insurance sector kept small,
  - No major non-bank intermediaries (except special finance companies),
  - Activities of foreign banks very restricted.
- Supervision focused at control of lending and accounting, no risk supervision.

- Competition restricted by regulations of interest rates, entry into financial market, etc.
  - Also new bank branches restricted.
  - Subsidiaries of foreign banks not allowed.
- Strong legal system (”Rule of law”)
  - e.g. bankruptcy procedures
- Very stable banking systems:
  - Very low loan losses,
  - Inefficiencies: large personnel and branch networks.
- Tight controls to protect independent monetary policy.

Main aspects of Nordic liberalization

- Growth of international trade and internationalization of firms.
  - This created pressures to liberalize.
- Growth of international financial markets.
  - IMF, OECD, EU sought liberalizations of markets and capital flows.
- Leakages and loopholes in the controls emerged.
  - ”grey” domestic financial intermediation in late 1970’s and 1980’s.
- Liberalization involves numerous acts, see next 2 slides.
  - Some volatility in macroeconomic developments during liberalization.

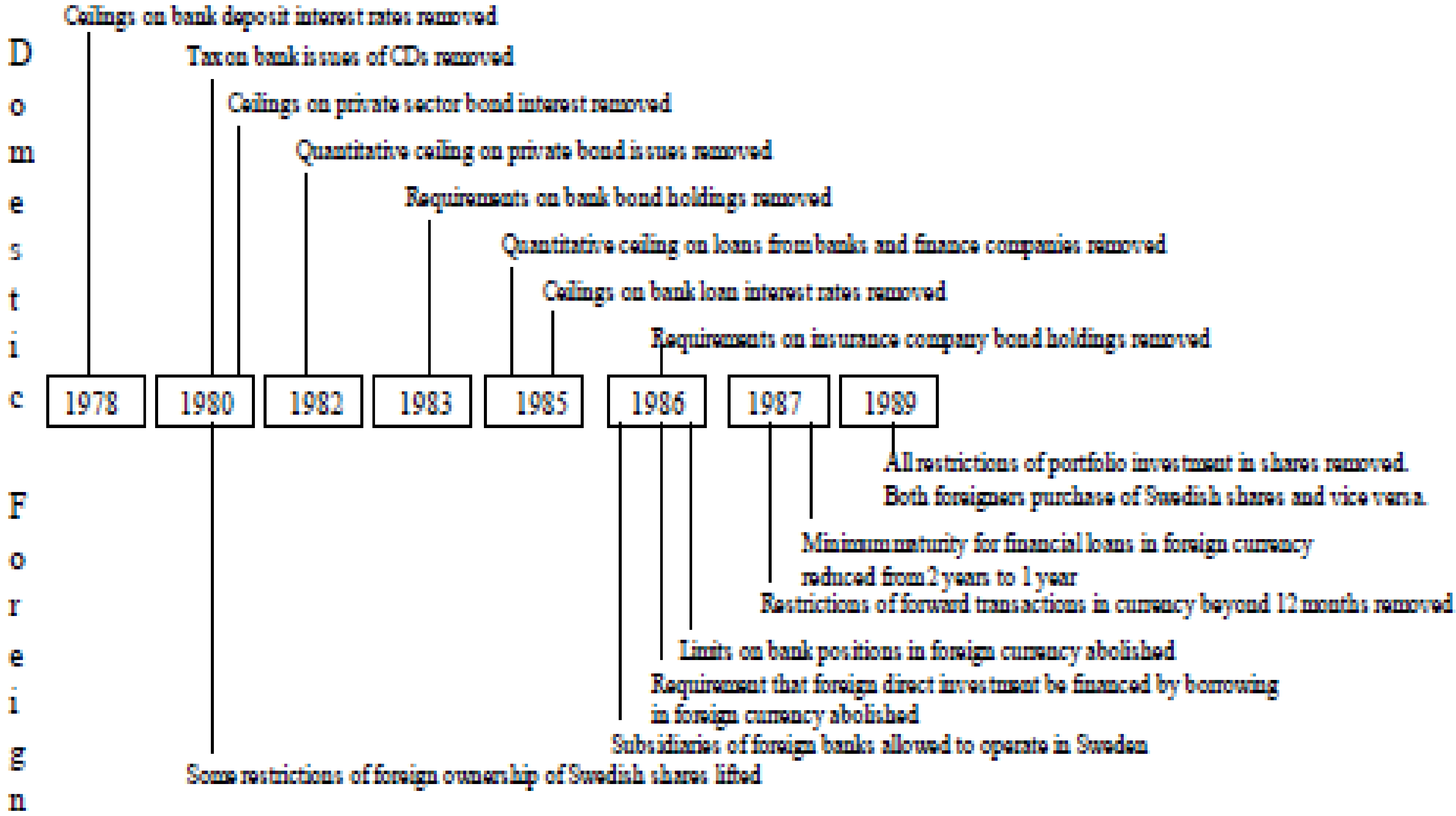


Chart 3.4. Deregulation of financial markets in Sweden

Source: Englund & Vihriälä (2003)

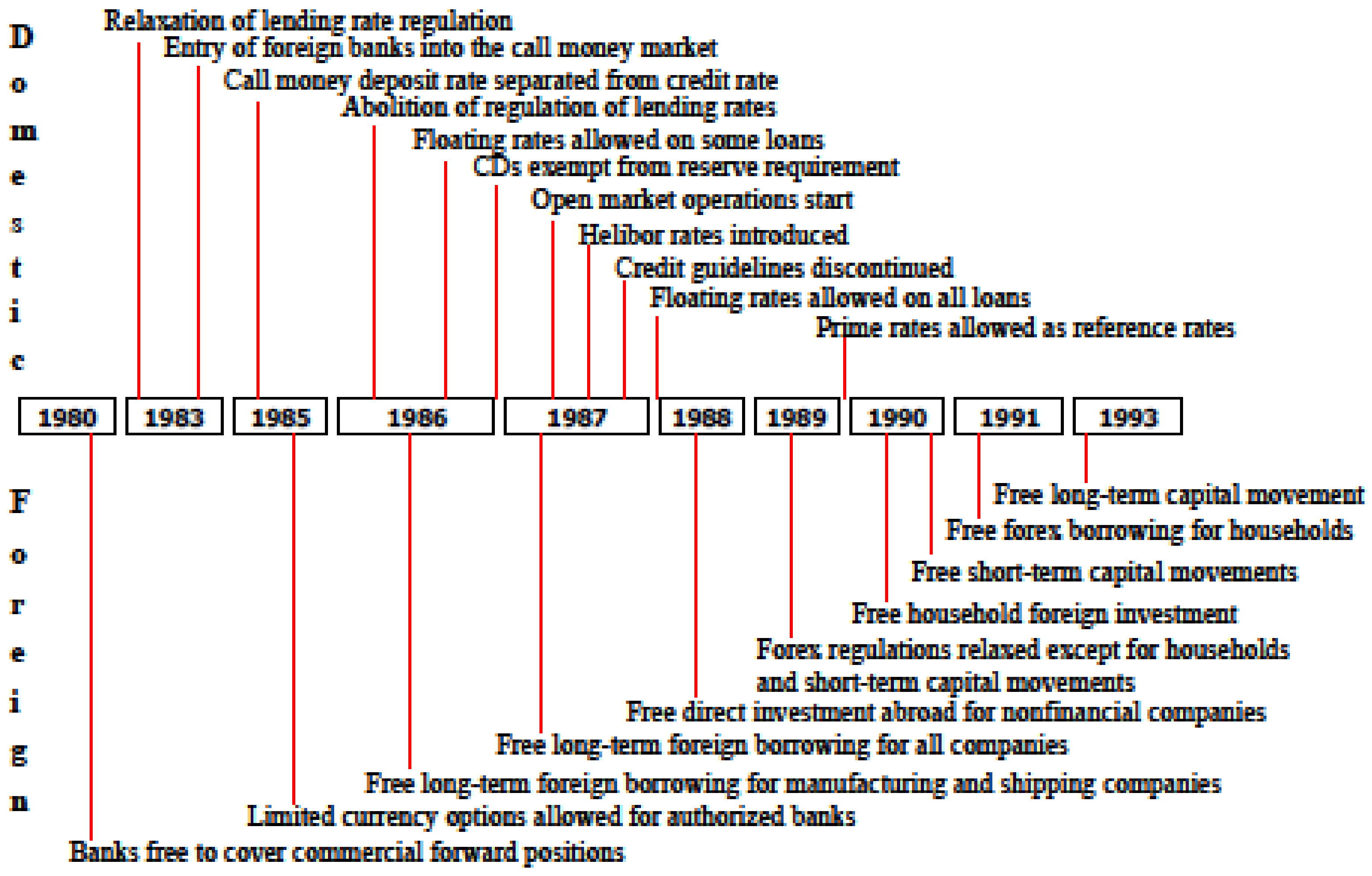


Chart 3B. Deregulation of financial markets in Finland

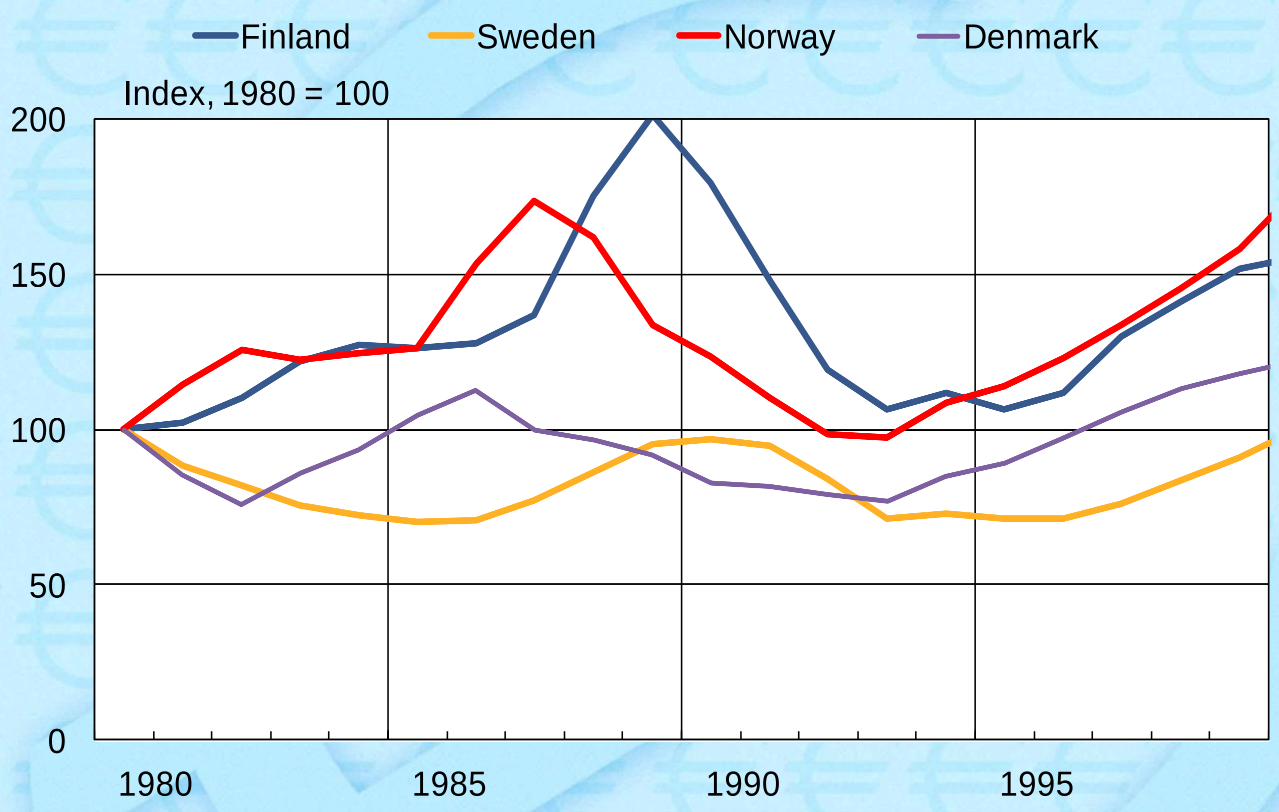
Source: Englund & Vihriälä (2003)

IV. Issues raised by Nordic liberalizations

- Liberalization financial and forex markets limits the leeway of domestic economic policy.
- **Impossible trinity:** with free markets one cannot fix exhange rate, domestic interest rate and quantity of finance.
- Order of liberalization:
  - Domestic market before international capital movements or vice versa?
  - Which order for different markets in terms of maturity, sector finance, derivatives etc.

- Other issues:
  - Which order for currency denomination (domestic vs. foreign)?
  - Which order for exports and imports of capital?
  - Should there be response to market pressure?
  - When might deregul. steps be reversed?
- Nordic countries liberalized domestic and currency markets and capital movements in tandem.
- Decisions about taxation:
  - Is debt finance favored?
- Consequences of Nordic liberalizations (figures)

Real house prices



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

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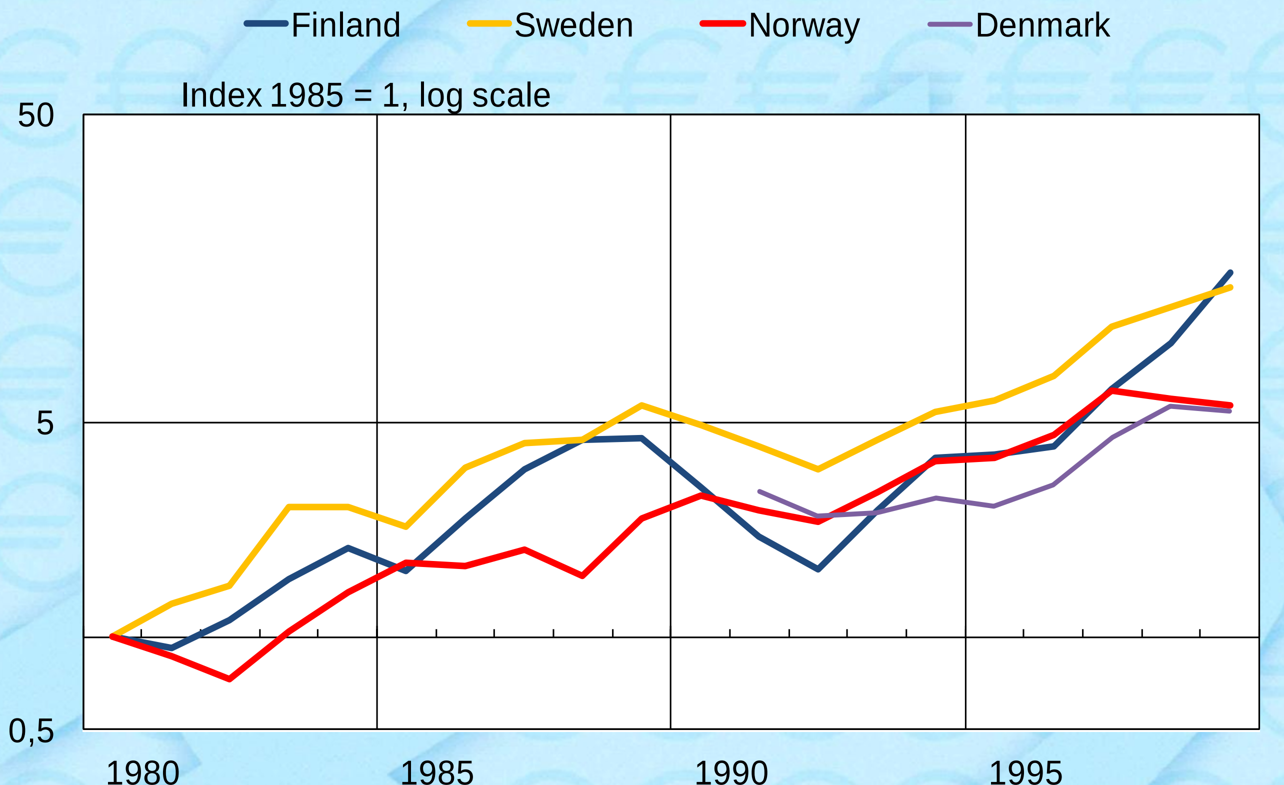
Real share prices



Nominal share prices deflated using the consumer price index.
Sources: IMF, ECB and Bank of Finland.
25125@Chart5 (en)

Problems in Nordic liberalization

- Bad timing, espec. for Sweden and Finland
  - big steps were taken in 1985-86, when business cycle suddenly turned upward.
  - Collapse of OPEC cartel -> lower oil prices. (Norway)
- A boom developed in Sweden and Finland:
  - Unsatisfied loan demands from households and domestically oriented businesses.
  - Tightening of banking competition, some banks adopted expansionary strategies.
  - Norwegian boom was cut short by the oil price drop.
- At the start of 1990's the boom turned into systemic banking, currency and economic crisis.
  - Norway experienced only a banking crisis.

- Denmark had banking problems but no systemic crisis.
  - Most other western European countries avoided a crisis.
- Lessons from the Nordic experiences:
  - Narrow focus on executing the acts of liberalization is not sufficient.
  - It is crucial to aid the adjustment of markets, firms, households and banks.
    - Toward relatively free competition with flexible prices.
  - Too little realization that liberalization implies increased risks.
    - Systemic viewpoint important
- The fixed exchange rate system came under pressure:
  - Floating of Fx rates in 1992, adoption of inflation targeting.

V. Lessons for China?

The financial system of China, main features

- Banking dominated by 4 state-owned banks
  - Non-state banks since 1996
- Stock market emerging, big role of state-owned companies
  - bond market small
- Gradual liberalization of financial sector combined with the dominant position of the state-owned banks in the banking sector have lead to emergence of unofficial financial system.
  - Some analysts claim ~25% of enterprise borrowing from unofficial sources, higher risks?
- No competition legislation, gradual lifting of limitations on competition.

- Weak enforcement of bankcruptcy and creditor rights.
- Central of role of the state in commercial decision making.
- Repeated recapitalization by state of big banks.
- Partial liberalization of interest rates with cap on deposit rates remaining, as well as floor on lending rates of housing loans.
- Crawling peg in exchange rates.
- Gradual relaxation of capital controls.

1980s Nordics and present-day China compared

- Both fairly open economies with open current accounts.
- Size difference huge.
- China is less advanced in terms of economic development:
  - Large state-owned sector with soft budget constraints
  - Real GDP per capita much lower than in Nordics in 1980s
  - much higher income inequality
- Risks of social tensions from reforms in China.
- Macroeconomic development in China favorable:
  - Growth rate, strong government revenues
  - Long period of balance-of-payments surpluses -> large reserves.
  - Much higher credit-GDP ratio in China

Comparing the financial systems

- Some characteristics similar:
  - bank-dominated financial system,
  - credit controls, moral suasion of banks, exchange controls,
  - lack of financial knowledge and risk management
- Nordic experiences are well documented.
- Financial opening need not result in a crisis (Denmark, rest of Europe).
- Nordic crisis did not lead to political backlash and facilitated moving to an more open economy; also, Nordic banks did not suffer in the 2008-9 crisis, except in Denmark...

Lessons?

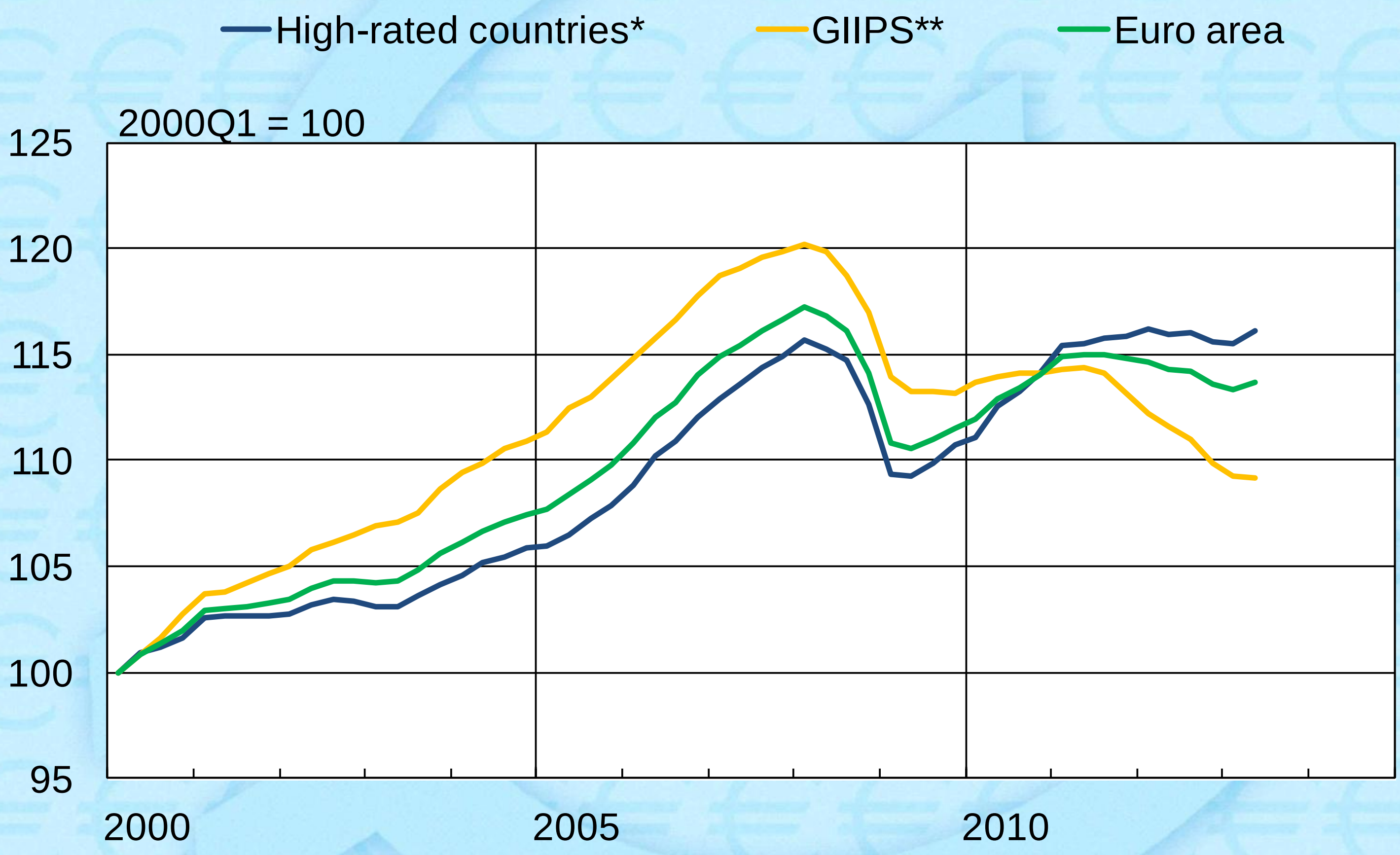
- Dangers from lack of financial knowledge
  - Traditional way of thinking becomes a trap.
  - This reform is much more than technical adjustments.
  - Bankers did not understand well the new system.
  - Adademics in universities can be out of touch.
- Important to time well acts of liberalization
  - To avoid pro-cyclicality.
  - Strengthen capital ratios of banks well before.
  - Reform of supervisory system in advance.
  - Reform fiscal policy and the taxation system.
  - Make exchange rate flexible before opening capital movements.

- Lessons continued:
  - A cautious and gradual approach is probably better than a ’big bang’.
    - International repercussions of the Chinese reform
  - In case a financial crisis emerges, it is important:
    - Take swift action to maintain stability and confidence of banking system.
    - Contain moral hazard when dealing with banking crisis.
  - Liberalization has long-run benefits for growth and development.
    - But a fully laissez faire financial system is likely to be unstable.

Final remarks: lessons from the Euro era

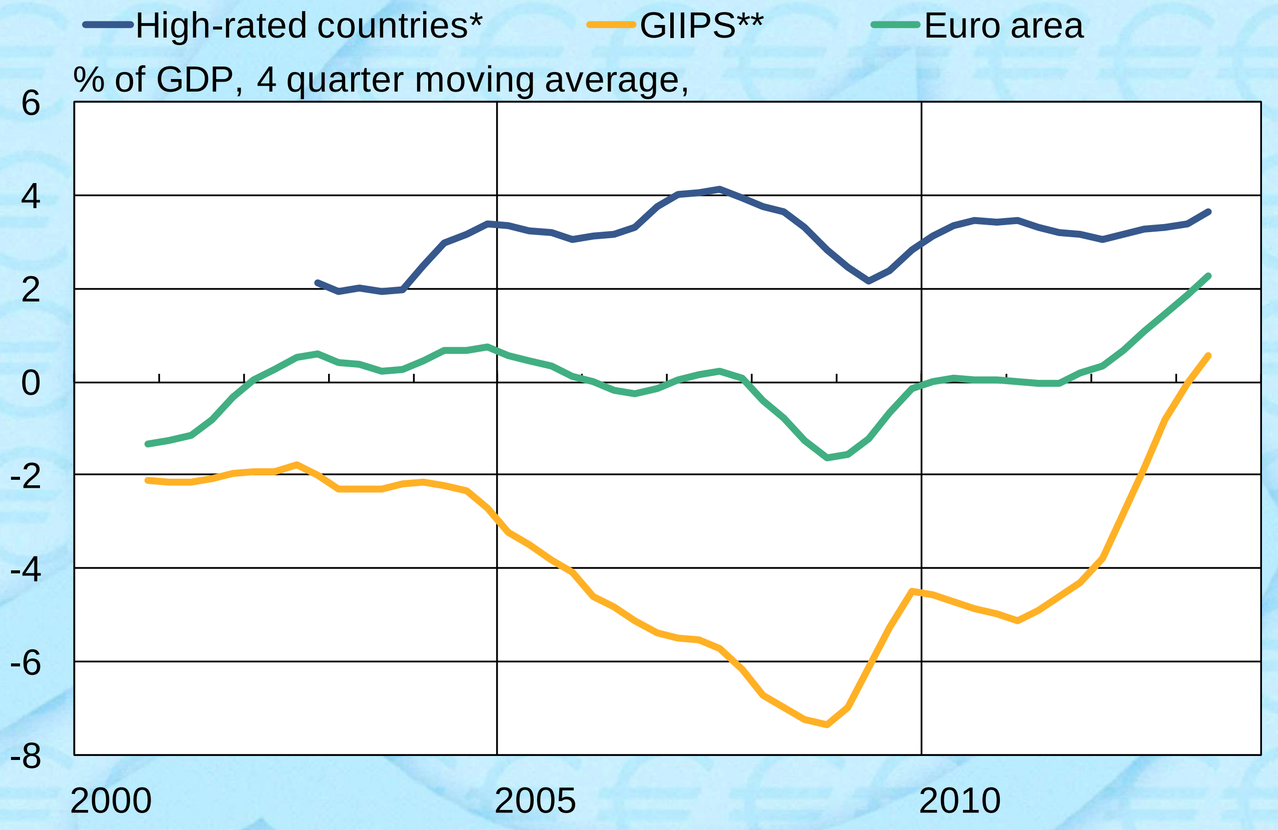
- I only discuss financial developments.
- Creation of the Euro area boosted financial development and integration further.
- Integrated financial markets with regulation and supervision at national level is an unstable configuration.
- Establishment of euro area led to macroeconomic divergencies:
  - Current account deficits emerged quickly.
  - Interest rate convergence first, then divergence.
  - Divergence of high-rated and crisis countries continues.
- New policies to correct the situations:
  - Strengthened economic and fiscal surveillance.
  - Preparation for the Banking Union.

GDP



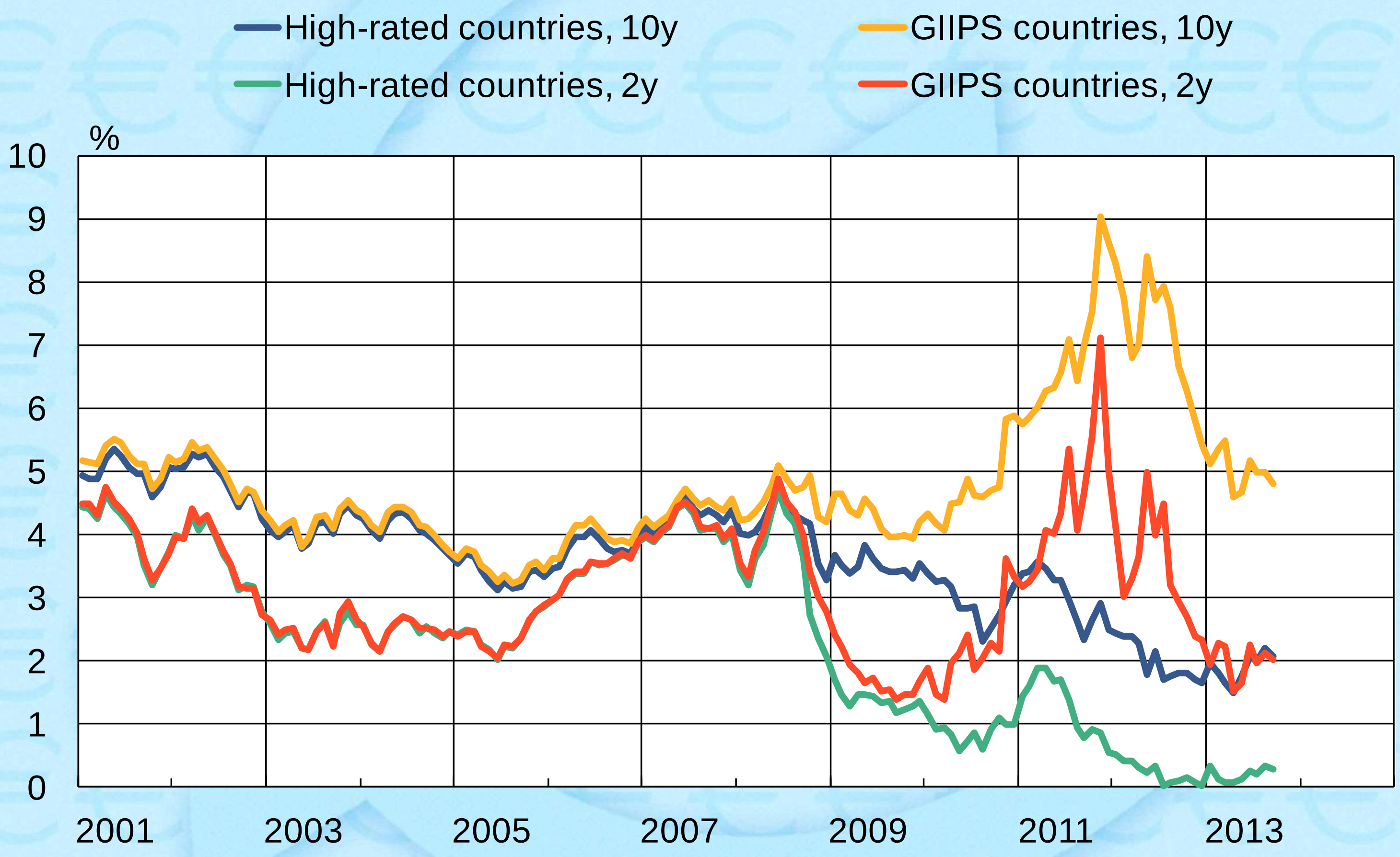
*Germany, France, Netherlands, Belgium, Austria and Finland.
** Greece (11-13 estimate), Ireland, Italy, Portugal and Spain.
Sources: Eurostat and Bank of Finland calculations.

Current account



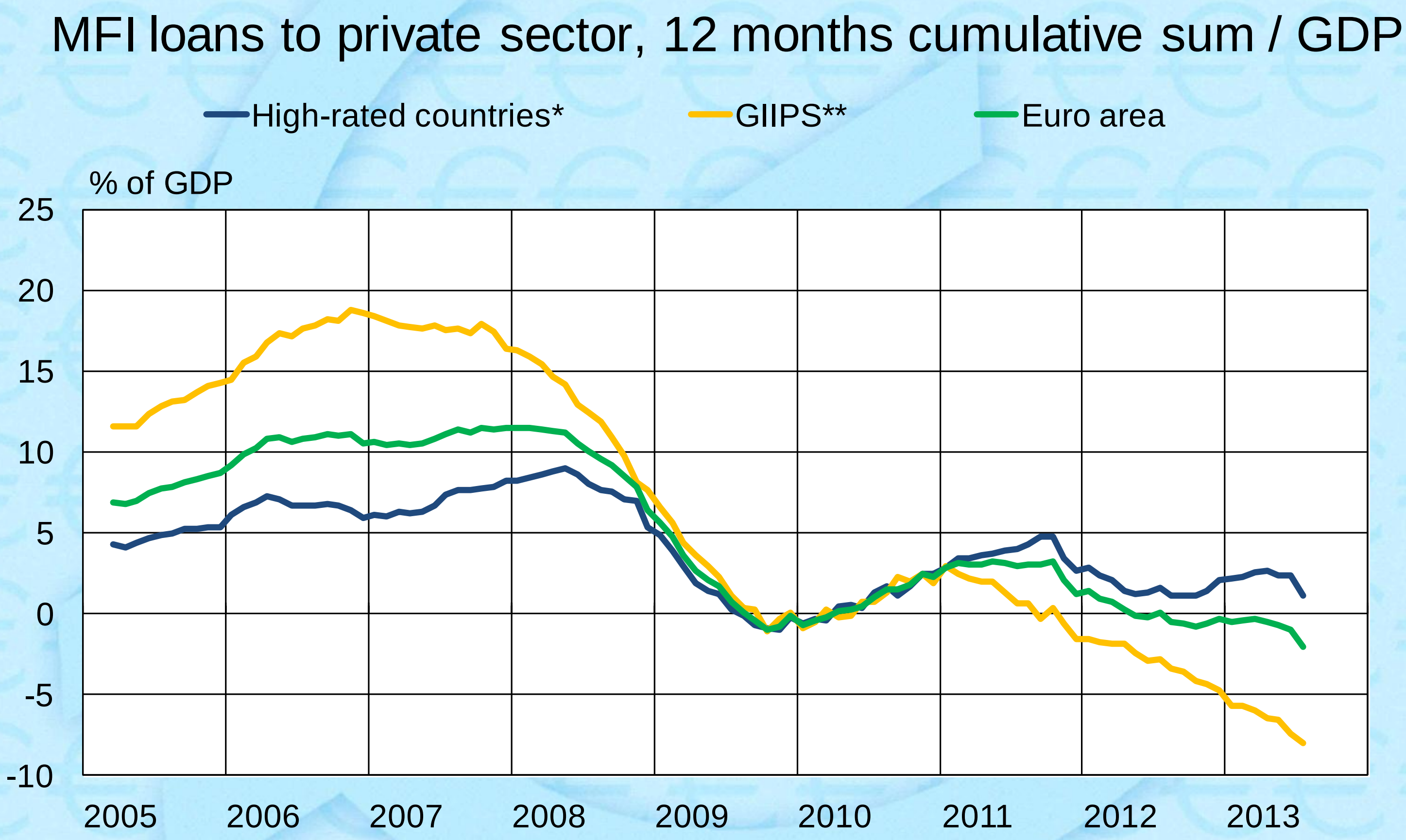
* Germany, France, Netherlands, Belgium, Austria and Finland.
** Greece, Italy, Ireland, Portugal and Spain.
Sources: ECB, Eurostat, and calculations by the Bank of Finland.

Sovereign debt yields



2 year yield excl. Greece and Austria. Weighted by nominal GDP.
Source: Macrobond.

MFI loans to private sector



* Germany, France, the Netherlands, Belgium, Austria and Finland.
** Greece, Italy, Ireland, Portugal and Spain.
Sources: ECB and Bank of Finland calculations.

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FINLANDS BANK

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EUROSYSTEMET

Thank you!