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Financial Crisis & Crisis Management in Sweden: Lessons for Today

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

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Introduction:

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"It" – where "it" stands for a deep financial crisis combined with depression – cannot happen here!

This was the general view held by economists, policy-makers and the public in Sweden prior to the early 1990s.



Introduction:

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But “it” happened

A deep financial crisis in 1990-1993



Introduction:

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A personal perspective:

I was there – seeing “it” unravel from the view of the office of the Prime Minister 1992-94.

Since then I have focused on crises and depressions in my research.



Why look at Sweden today?

1. The Swedish crisis management (the Swedish model of bank resolution) attracts much interest as a result of the present global crisis. ("We are all Swedes")
2. Sweden has a tradition of open, transparent and frank public debate and disclosure
3. A modern and rich welfare state based on consensus – interesting for other countries, in particular for small open economies.



Plan of the paper:

- 1. The causes of the financial crisis*
- 2. The Swedish model for bank resolution*
- 3. Can the Swedish model be exported today?*
- 4. Conclusions*



The anatomy of the financial crisis of the early 1990s

A "classical" story of boom and bust triggered by financial liberalization cum a pegged exchange rate, lax monetary and fiscal policies, lax financial supervision.

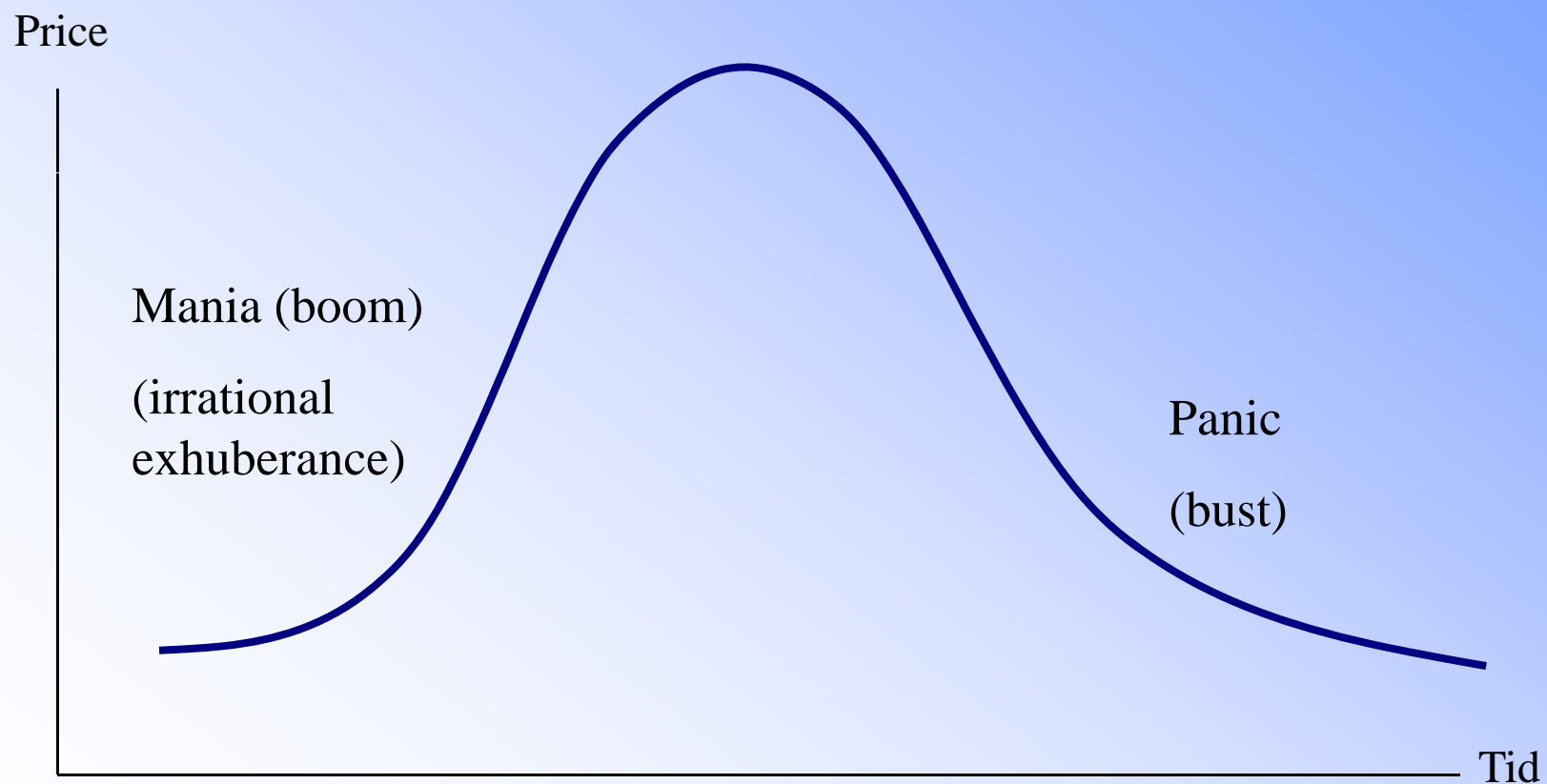
Bad policy, bad regulation, bad banking (and bad luck)



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The anatomy of the financial crisis of the early 1990s

Boom 1985-1991 Bust 1991-1993 Recovery 1993-2001

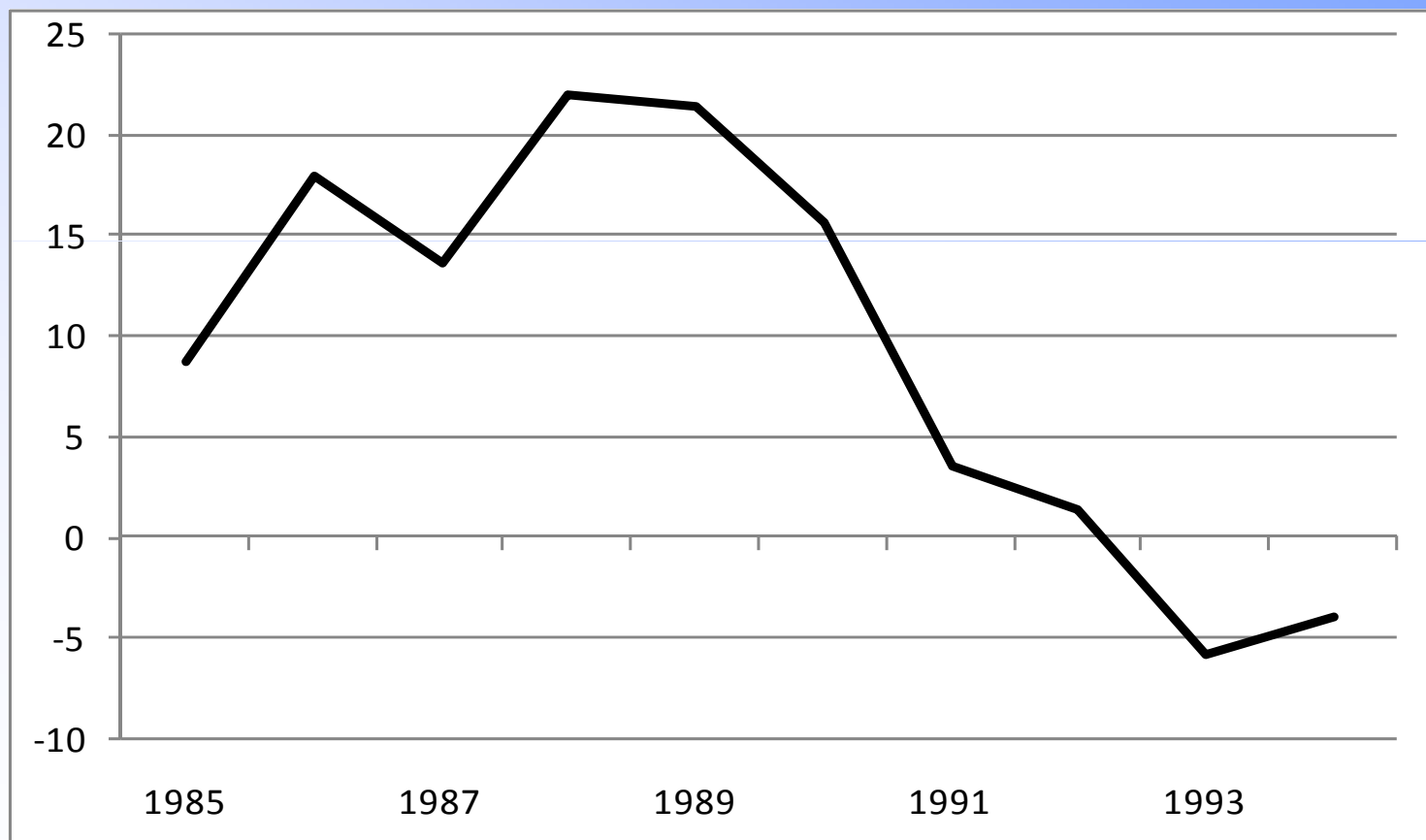




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The anatomy of the financial crisis of the early 1990s

Growth of credit 1985-1995

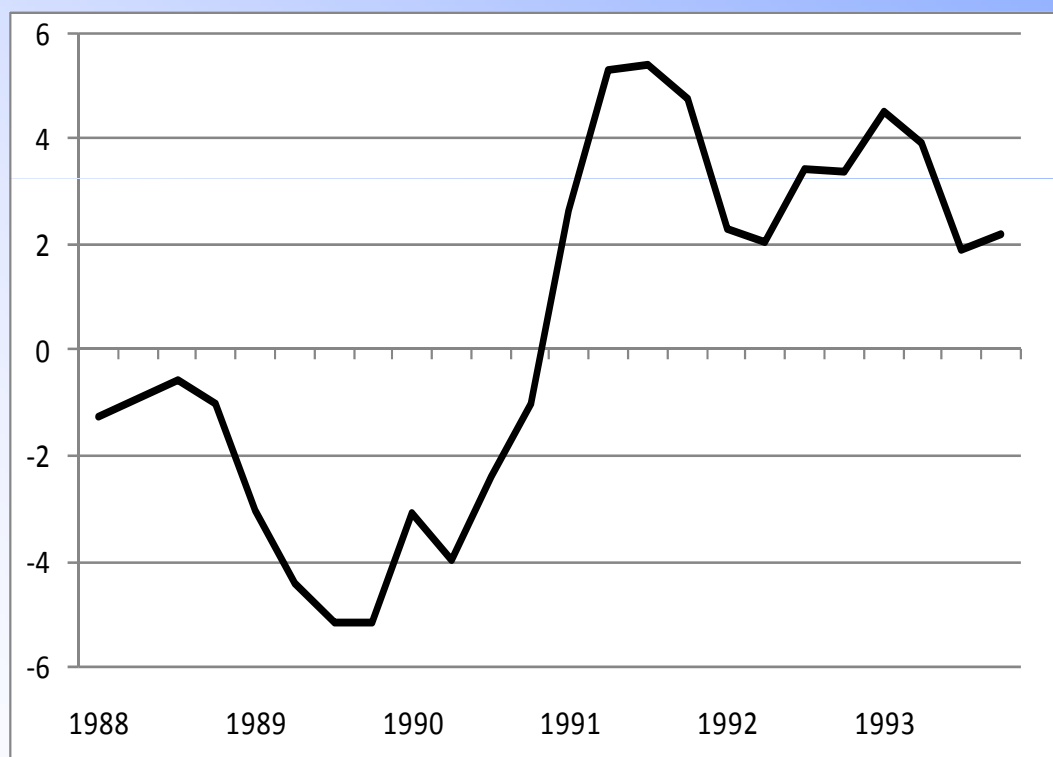




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The anatomy of the financial crisis of the early 1990s

The after-tax real rate of interest

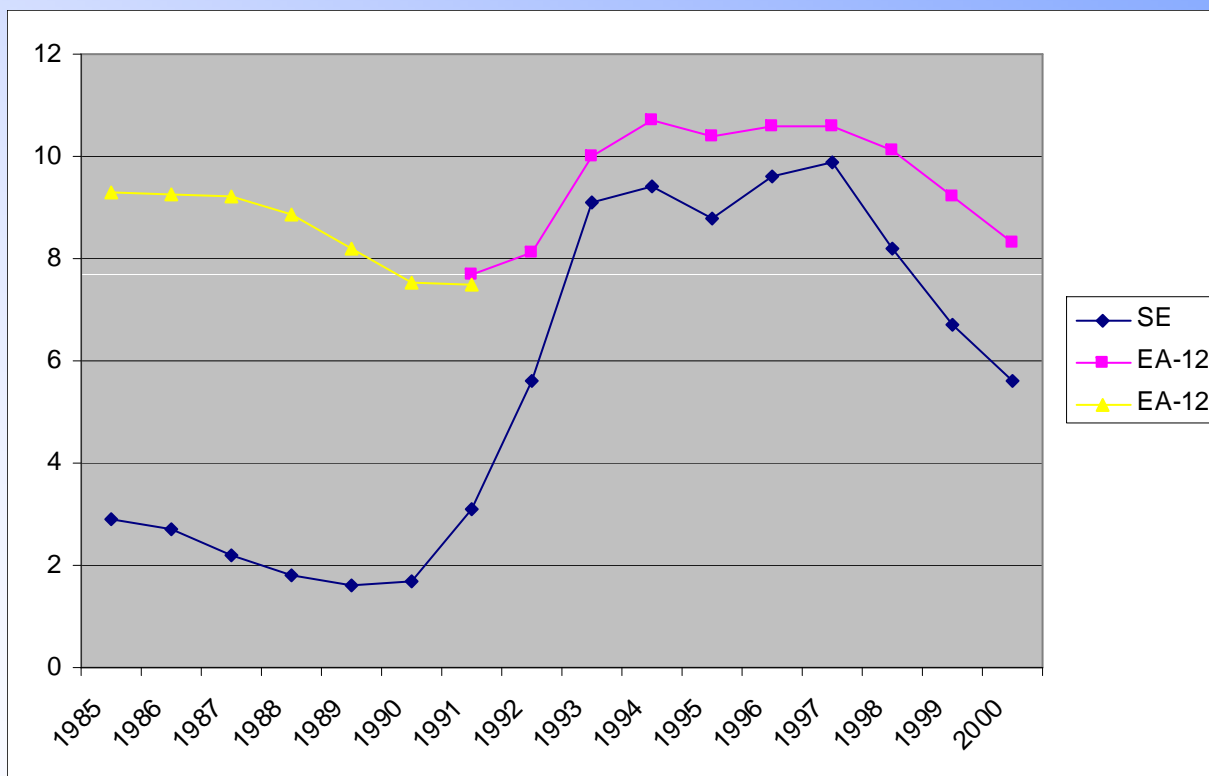




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The anatomy of the financial crisis

Rate of unemployment

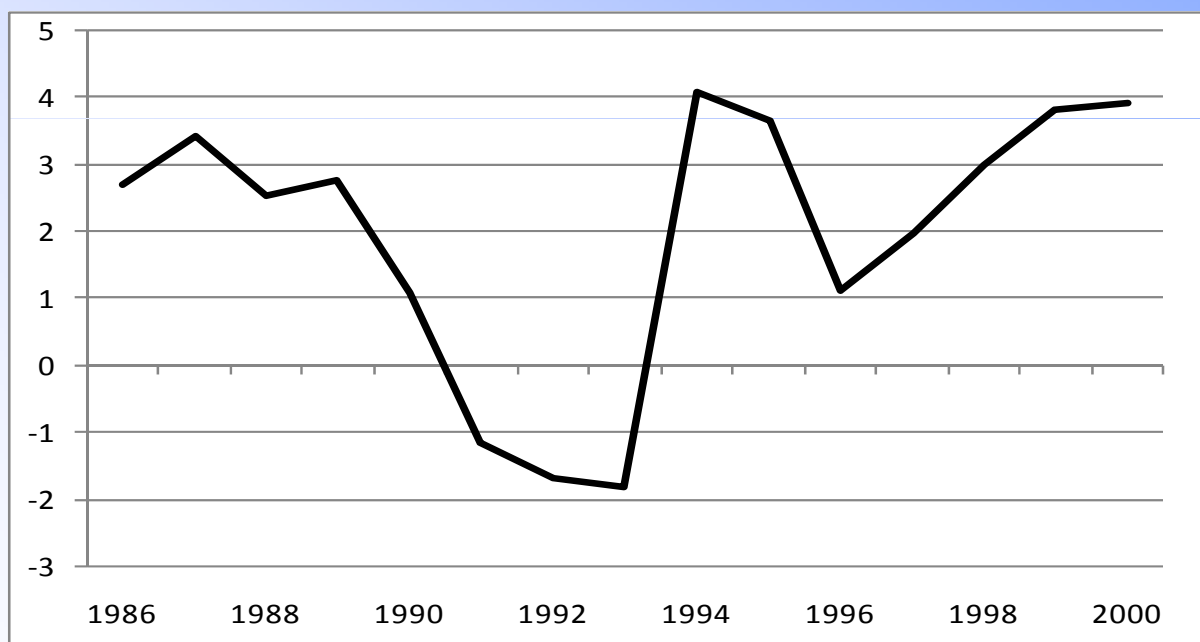




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The anatomy of the financial crisis of the early 1990s

Real GDP growth





The Swedish model of bank resolution

1. *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 of bank resolution

The blanket guarantee had clearly positive effects, as it came early during the Swedish financial crisis, as it prevented the likelihood of bank runs, from either international or domestic sources, and as it gave the Riksbank the opportunity to more actively support the banking system.

Bearing in mind that Sweden is a small, open economy, access to international financing was crucial to it after the abolishment of capital account controls in 1989.



2. 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

Political unity eased the passage through parliament of measures to support the financial system.

In addition, representatives of the opposition had a full insight into the resolution process, thus maintaining political accord.

The agreement between the government and the opposition lent credibility to the actions of the government and of the Riksbank.

Political unity was most necessary in terms of adopting a swift, decisive and lasting approach.



The Swedish model of 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.



The Swedish model of bank resolution

Of course, there was a risk that a rapid policy response might be too rapid, leading to inadequate measures that would have to be changed in due course. However, in hindsight, this risk proved worth taking.

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.”



The Swedish model of 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 of 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 open-ended funding underpinned the credibility of the bank resolution policy. It clearly demonstrated that there were no political misgivings about the financial commitment to support the banking system.

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 of 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 of bank resolution

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.



The Swedish model of bank resolution

The general strategy was to divide the banks into three categories, depending on whether the statutory capital adequacy ratio would be breached and, if so, whether this breach was temporary:

The first category included those banks that might deteriorate towards the capital adequacy limit, but would subsequently be able to achieve enhanced solvency on their own;

The second category covered those that may fall below the limit for a time, but would eventually recover; and

The third category was for those that were beyond hope.

Each of these three categories was treated differently by the Bankstödsnämnden.



The Swedish model of bank resolution

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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 addition, when assets were placed under the administration of Securum and Retriva, they were assigned low market values in the due diligence process, effectively setting a floor for asset values. Because market participants did not expect prices to fall below this level, trading was maintained.

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.



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.



The Swedish model of bank resolution

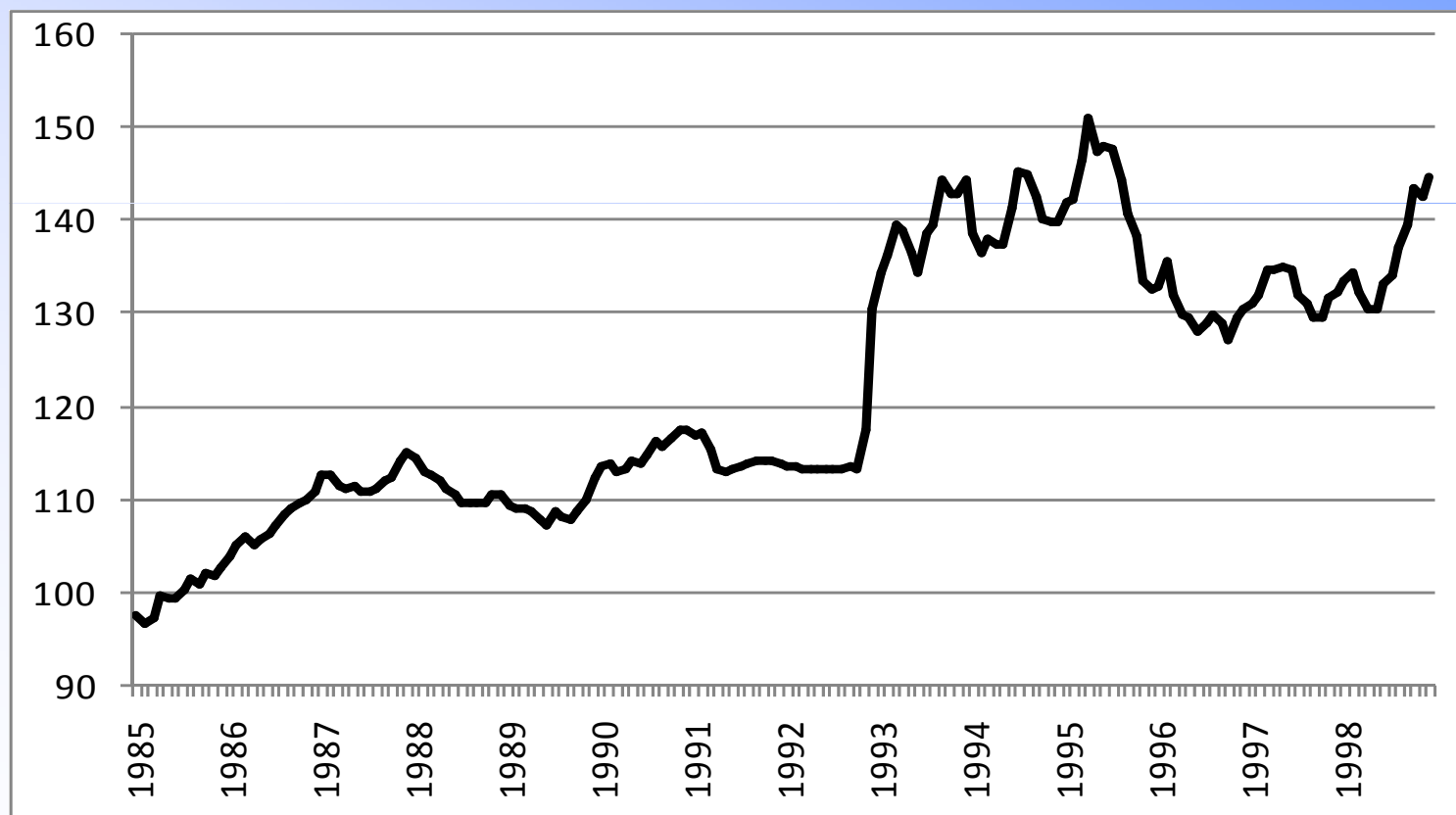
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Once the krona was floating, monetary policy was able to focus on domestic conditions. The Riksbank gradually lowered interest rates, although critics claimed that the reductions were too cautious. The vicious circle of falling asset prices was arrested. 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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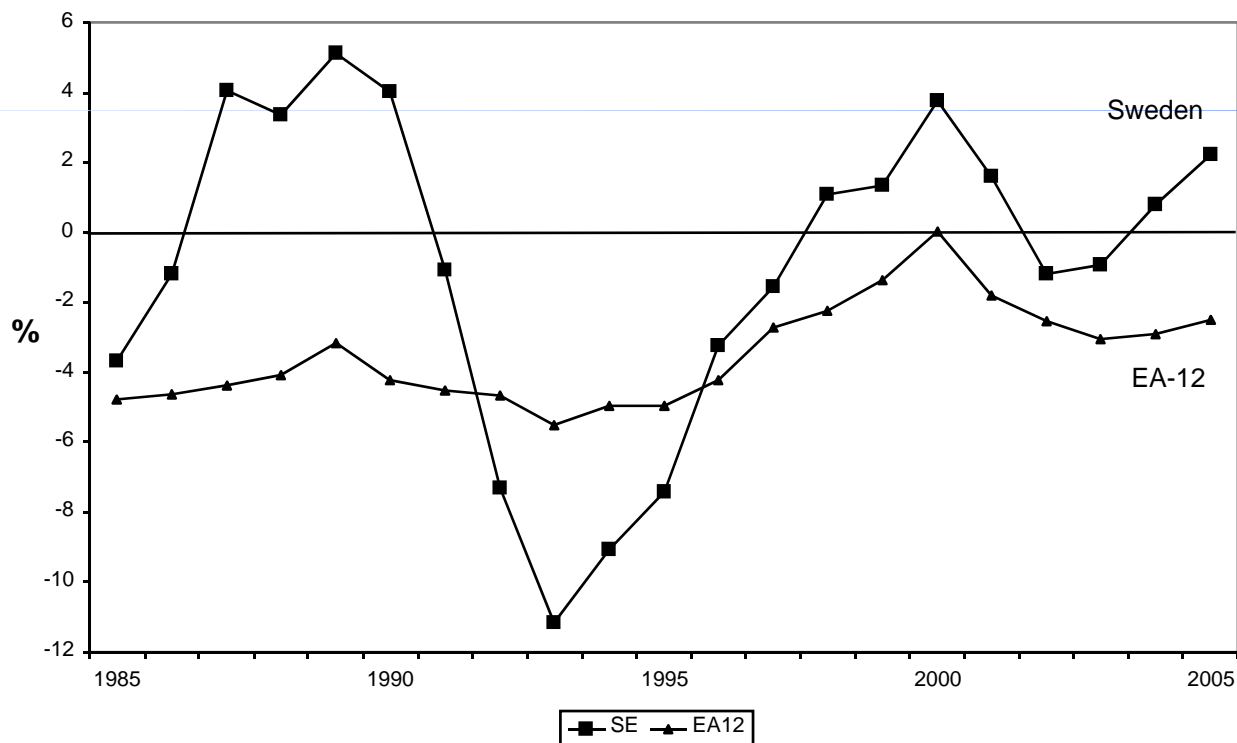
The exchange rate of the krona (ecu)





The Swedish model of bank resolution

Figure 6 The budget deficit to GDP in Sweden and the EA 12, 1985-2005.
Percent





Evaluating the Swedish bank resolution

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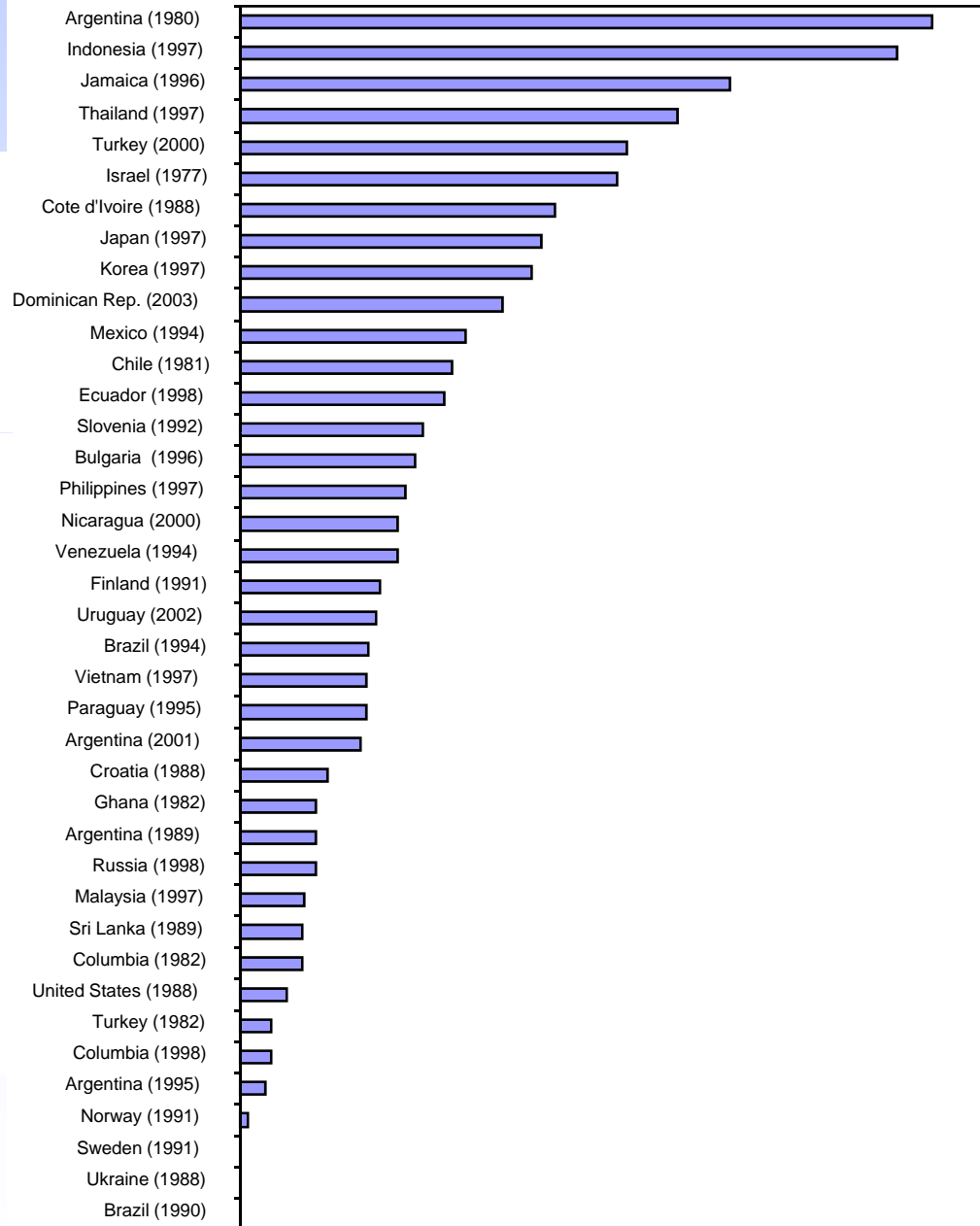
The Swedish bank resolution policy is commonly regarded as successful in the international policy debate, although there are no firm criteria on how to evaluate resolution policies.

- One reason for this positive view is the fact that the banking system remained fairly intact;
- It continued to function during the crisis,
- There were no bank runs,
- Hardly any signs of a credit crunch emerged,
- 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 low



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Figure 11. Net fiscal costs from systemic banking crises, 1970-2007, per cent of GDP.





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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.



4. 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 and financial innovations, setting off a credit boom.

The boom was supported by lax monetary and fiscal policies. The private sector, households, firms and financial institutions ended up over-indebted. Financial supervision and regulations were inadequate to prevent the boom and the emergence of large financial imbalances.

Eventually, boom turned into bust - with a declining volume of credit, deleveraging, falling asset prices, and distress in the financial system, bringing the threat of bankruptcy of major financial institutions, and triggering heavy government intervention to support the banking system.



4. Can the Swedish model be exported?

There are considerable differences between the Swedish crisis of the 1990s and the current global financial crisis.

Most important, the initial conditions for Sweden compared to those of most other countries today are significant.

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.



4. *Can the Swedish model be exported?*

The option of an export-oriented growth strategy out of the crisis is currently not open to the world, 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.



4. 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, in fact - in a global environment of trust in the banking system and in financial markets (except for the Nordics).

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.



4. Can the Swedish model be exported?

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 securitization etc.

Structured products were not traded in local and global markets, re-leveraged to create other securities, and then traded again.

While bank leverage and institutional leverage played an important role in Sweden in the early 1990s and continue to do so, the market leverage and degree of complex and opaque securitization today is quite different from the situation in Sweden in the late-1980s.



4. Can the Swedish model be exported?

The ongoing global crisis is both a banking crisis and a financial market crisis, by contrast with the Swedish crisis, which was primarily a banking crisis, and only later became a currency crisis – a twin crisis when the krona came under attack by speculator.

In particular, both local and global systemically-important markets serving the short-term liquidity and funding needs for a wide range of financial institutions and hybrid financial-non-financial companies have been under severe stress – and at times not functioning at all – since the advent of the US subprime crisis in the summer of 2007.



4. Can the Swedish model be exported?

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. Trust contributed to the belief that the Bankstödsnämnden was going to carry out its duties in a fair and correct way without favouring any of the parties involved.

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.



4. Can the Swedish model be exported?

The differences between Sweden in the early 1990s and the situation today suggests that it was easier for policy-makers 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.

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

Policy-makers trying to support the financial system today are facing greater challenges.



Conclusions

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The financial system is based on trust.

History demonstrates that a deep financial crisis, like the one that hit Sweden in the early 1990s, is associated with a severe lowering of confidence in the liquidity and solvency of the banking system.

Under such circumstances, the goal of economic policy should be to ensure confidence in the workings of the financial sector, thereby arresting the 'melt-down' and paving the way for recovery.

The way to do this is to inject capital into the financial system, and to recapitalize banks and other institutions, because the private sector is not able to do so in the short run – only the public sector has this capacity. Once the public believes that the financial system is stabilized, trust will return. This is an important lesson from Sweden.



Conclusions

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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.

The Swedish model created proper incentives for bank managers and bank owners. This is hardly the case in the US today.



Conclusions

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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.

A detailed knowledge of institutions, legislation and political conditions in the country involved is needed. The Swedish recipe for bank resolution as a role model for countries facing financial crisis can be summarized as general template, the detailed application of which should be left to the other countries as an open venture.



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