SPEECH

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Financial crises in an international perspective

Thank you for inviting me here today. It is easy to forget what a financial crisis entails, now that a number of years have passed since we last experienced one and it is therefore important that we remind ourselves. Although we cannot yet see any immediate threats, we must look ahead to prevent potential crises.

During my twenty minutes or so today I intend to talk about the following:

- the fact that most of the various crises in different countries during the 1980s and 1990s have had a number of common causes,
- the fact that it is important to invest in preventing and managing crises,
- the fact that risks and potential vulnerabilities in the financial system are now changing rapidly as the differences between banks and other financial institutions decline and cross-border integration intensifies,
- the fact that the cooperation between authorities within and between countries must be developed further, both with regard to regular monitoring and crisis management. In particular, it is necessary to discuss how the responsibilities and costs should be divided up in the event of a crisis.

Many of the experiences I describe refer to crises and countries outside of Scandinavia, even outside of Europe, which does not prevent them from being relevant to our discussion. However, I will in some cases refer directly to the situation in the Nordic countries, with regard to the advantages and also the challenges presented by the far-reaching integration of our financial systems.

Introduction

An IMF study published a few years ago indicated around 130 financial crises in a fifteen-year period during the 1980s and 1990s; some countries were afflicted more than once. As we all know, we have also had our share of crises in the Nordic countries. Denmark has managed better than the other countries – you had no acute systemic crisis, but a few incidents where individual banks suffered major losses. Many international studies point to the large costs linked to crises – costs to individuals, companies and society as a whole, both direct financial costs and indirect social costs. For example, the crisis in Indonesia cost around 60 per cent of the country's annual GDP. A World Bank study shows that poverty combating in this country was reversed by twenty years. The conclusion is, of course, that it is very important to prevent crises and to manage crises in a way that minimises damage.

In my earlier work at the IMF, I was directly involved in crisis management in several countries, but also in the prevention work. My assessment is that many countries have made considerable efforts in recent years to reduce the vulnerability of their financial systems. At the same time, much remains to be done, not least to meet the constant changes in the financial world. What gives me hope that this will really happen is that international pressure has increased – countries wishing to become full members of the global financial system are forced to at least live up to an international minimum standard.

So which are the factors that lead to crises and how should they be dealt with?

Experiences of crises in a large number of countries around the world

It is possible to divide crises into those that only affect the financial sector and those where the financial sector forms part of – and aggravates – a broader economic crisis, as was the case in Sweden in the 1990s. The broader economic crises are usually based on untenable macroeconomic imbalances. Large deficits in central government finances or in the current account, unrealistic exchange rates or similar. One experience that Sweden shares with many other countries is that large and essentially desirable deregulation processes and other policy changes may lead to crises if they are not managed properly. The broader crises are more comprehensive and more difficult to resolve, partly because the possible solutions are not as clear-cut and entail weighing different social interests against one another. However, even the crises that specifically affect the financial sector, usually primarily the banks, often have their roots in weaknesses outside of the sector. These crises often result from a combination of "bad policies, bad banking and bad luck".

According to the studies made by, for instance IMF employees, bank crises have often been due to one or a combination of these factors:

- A lack of competence in the banks, which has combined with weak regulation and supervision to lay a foundation for potential problems. This could be a question of inadequate credit granting policies, exaggerated confidence in loan collateral, an inability to detect risk concentrations.
- Criminal abuse of the banks, such as improper actions by owners and other insiders or "common criminals" such as Nick Leeson at Barings.
- Malpractice by the authorities towards the banks, for instance non-commercially directed lending.
- Many countries also suffer from their supervisory authorities lacking sufficient independence. The government becomes involved in the authority's operational decisions and prevents the necessary measures from being implemented against problem banks.

- Weaknesses in structural factors, such as laws and courts. There may also be flaws in the financial security net, for instance deposit guarantees or rules for closing down banks, which mean that the authorities postpone dealing with problems that have arisen for as long as possible.

The crises can be aggravated and the solutions can become more severe and more expensive in some cases, for instance if the central government itself has poor finances or is bankrupt (Indonesia 1998). It then lacks the capacity to intervene with sufficient financial support measures to manage the crisis. If the country is strongly dollarised or has a currency board (Argentina 2001) or another form of fixed exchange rate regime, there is no possibility to take certain measures, such as supply the economy with a large amount of liquidity. Finally, I have seen that in the cases where the financial sector is large in relation to the rest of the economy (Thailand 1997), the negative contagion effects to society as a whole are much greater.

How can one prevent financial crises? In my experience, much can be achieved if the authorities and the financial participants together draw up effective preventive measures and plans for good crisis management. One clear and positive conclusion from the crises in the past twenty years is that good crisis management can save large amounts of money and reduce disruptions to society. On the other hand, it has been demonstrated that bad crisis management aggravates crises, partly by spreading uncertainty among the general public and the financial market agents.

Good crisis management involves creating good laws, regulations and supervision. I have seen deficiencies in these fields in many countries. The legal framework may be insufficient, including the external conditions for good supervision, such as poor auditing and accounting. In some countries it is even possible to question whether a rule of law prevails there; that is to say, whether the laws are the ultimate guiding principle as to how the country is governed.

Managing a crisis also requires laws and regulations that enable a problem institution to be closed down quickly or managed in some other way. Sometimes it is necessary to take measures very quickly, perhaps even the same day. It is not possible to wait for the usual court process to be completed. To avoid this leading to any form of malpractice, the injured party should have the opportunity to obtain redress and damages afterwards. We had this kind of a law in Sweden during our financial crisis.

Another question is when a court should be allowed to stop important authority decisions intended to deal with acute bank problems, such as closing a problem bank. When a bank needs to be closed, a difficult balance arises, between the owners' interests and the savers' interest, which are both safeguarded in law. One very current example of this dilemma in Sweden is the case of Custodia. Both the country administrative court and Finansinspektionen (the Swedish financial supervisory authority) have made their assessments on the basis of what they should take into account, that is to say the customers' interests and the company and owners' interests respectively. However, I feel that it is very unsatisfactory that we in Sweden do not have a clear legal framework that can manage this type of situation and I assume that these difficulties will quickly be repaired.

Crisis prevention also includes creating sufficiently strong public authorities. Unfortunately, one can see that the authorities in many countries have insufficient resources, independence and competence to match the often financially strong and rich in expertise financial institutions, whose owners can moreover all too easily gain the support of politicians against the supervisory authority's demands for measures. This is of course a more serious weakness in a problem situation where a lack of measures, insufficient measures or delayed measures can aggravate the crisis. Another problem, although fortunately one we do not have in the Nordic countries, is harassment of the management and personnel within the public authorities for the purpose of reducing their ability and willingness to take supervisory measures against wrongdoing banks.

In addition, it is important to establish clear roles and areas of responsibility between public authorities within the same country, between authorities in different countries and also between the authorities and the financial institutions. I have seen that in some countries it is unclear which authority makes the decisions, or which authority has the power to decide on a particular issue, because the law is unclear or because it is not followed in practice. This lack of clarity is accentuated in a crisis situation and hampers crisis management. This can be expressed in different ways, such as poor coordination between the authorities with regard to public statements and decisions or territorial conflicts arising and special interests being favoured over general solutions.

If one wishes to detect problems in good time, before they develop into a crisis, it is important that the public authorities within a country and those in different countries can coordinate and exchange information. There have been large inadequacies in this field in previous crises. This can to some extent be blamed on confidentiality regulations, and the relevance of these may be questioned during a crisis, but in all honesty it can also be blamed in many cases on the authorities having insufficient interest in collaborating.

Tendencies in the financial sector

The financial sector is subject to rapid development. The borders between different financial activities are being eroded. Banks are selling insurance-like products and insurance companies are selling banking products. In some cases financial conglomerations are being established. Moreover, the trade in financial instruments has developed to such an extent that the risks are spread to a greater number of agents than before and also spread outside of the banks and insurance companies.

Another development is the cross-border integration, particularly in the Nordic countries. Danish banks have established themselves in Sweden and Swedish banks in Denmark. Integration as such is a positive development, for several reasons and not least to increase economic growth. The Riksbank therefore supports measures, for instance within the EU, that lead to greater integration. It is therefore important that the authorities manage the risks that integration might entail to avoid setbacks. In addition to the complications that follow on from an institution being established in several countries, supervision and risk management are made more difficult by the banking group sometimes choosing to manage the risks on a functional basis and not in accordance with the bank's forma organisation. For example, a bank with operations in several countries can choose to locate all of its credit management to one country and its liquidity management to another country.

In general, this development strengthens financial stability. The capacity to identify, manage and reduce risks has increased. The institutions' cross-border operations make them less dependent on how the economy of an individual country develops. However, at the same time a number of new possible problems arise, which must be prevented and managed by institutions and authorities. Risks and vulnerabilities may fall between different authorities' or countries' fields of responsibility and thereby may go unnoticed. Or, if they are noticed, territorial conflicts may arise, making it more difficult to implement the measures needed. It may also be unclear where the risks will end up. Bank supervision can ensure that the banks have sold certain risks, but it is not clear whether the buyers have the knowledge and financial strength to manage these risks. In the worst case scenario, the risk will return to the bank in a loss situation.

The development I have described must be met with increased harmonisation of regulations and supervision, both between sectors and between countries. This has already been achieved to some extent within the EU, but it needs to be achieved on a global basis. Moreover, the coordination and exchange of information must be strengthened both in "peacetime" and during crises. Not surprisingly, I consider it important to implement regional financial stability analyses to detect possible vulnerabilities; the type of analyses now being made in the IMF-led exercise in the Nordic-Baltic region. Furthermore, both the institutions and the public authorities must gain greater knowledge of where the risks end up and what might happen if the ultimate risk-takers suffer problems.

The Nordic countries and the Baltic countries

Financial integration has come a long way in the Nordic and Baltic countries. There is a close collaboration between the central banks and financial supervisory authorities in the Nordic countries. We have agreements on consultation in the event of crises and we hold joint crisis exercises. As Swedish banks play an important role in the Baltic countries, discussions are under way on the signing of aconsultation agreement between the Swedish and Baltic authorities. One important weakness that remains is the unclear distribution of the financial costs between countries in the event of a crisis. A closely-linked but also unsolved issue is which country's assessment of the situation will prevail and who may decide on measures such as closing a bank. Are the Danish taxpayers prepared to help pay to save Nordea's operations in a crisis or do you see it as a problem for the Swedes alone? The question can be reversed, to ask how we Swedes would regard a crisis in Danske Bank.

These issues are not unique to our countries; they apply to all countries and therefore require wide-scale international management. This is a difficult but important issue to discuss – before the next crisis occurs. One means of making this issue more concrete could be to hold a new Nordic crisis exercise based on the conditions in a real bank. It would be necessary in this type of exercise to take a stand on the specific case, which in turn might make it easy to continue a general discussion.

Conclusion:

The crises during the 1980s and 1990s led to many important measures being taken:

- A number of international standards were adopted to create global minimum standards for regulation and supervision, for instance the Basel Committee's Core Principles for effective banking supervision. The tasks of the IMF and the World Bank were increased to systematically identifying vulnerabilities in countries' financial sectors, proposing measures to remedy them and giving technical assistance. The private agents in the financial market have also taken initiatives to reduce risks. They have, for instance, established the CLS Bank to reduce risks in foreign exchange trading.

The banks and public authorities currently have a much better grasp of the risks in the financial sector and how these can be managed and reduced – this is probably part of the explanation why we have seen a clear decline in the number of bank crises in recent years. At the same time, the developments I have outlined above, including the creation of large financial groups and payment centres, lead to new types of risk that need to be managed. The consolidation on the part of the market must therefore be met with increased coordination on the part of regulations and public authorities.

We do not need more regulation and supervision; the challenge is that regulation and supervision must always be adapted to development and, as now, aimed at detecting and remedying the most critical vulnerabilities in the financial system. This sounds obvious, but it is not so easy to achieve in practice. Commercial developments are rapid, while it always takes a little longer to adapt laws and public authorities, particularly if regulation and supervision are at the same time to be harmonised across national borders. From my work in various international forums, I know that the Danish authorities in general share my views on the importance of the issues I have mentioned today and I look forward to continued cooperation with you in various ways to prevent financial crises and thus avoid having to manage them together.