Speech

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Financial Crises: the Swedish experience

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Thank you for the invitation to talk about financial crises in general and the Swedish experience in particular.

What is a financial crisis?

Financial crises and their subset, banking crises, have become worldwide phenomena during the 1990s. Up until a few years ago, views on financial crises were split into two polar camps—those associated with monetarists versus a more eclectic view.

Monetarists have linked financial crises with bank panics. They stress the importance of banking panics because they view them as a major source of contractions in the money supply which, in turn, have led to severe contractions in aggregate economic activity. Monetarists do not view as real financial crises events in which there is no potential for a banking panic and a resulting sharp decline in the money supply, despite a sharp decline in asset prises.

An opposite, but more traditional, view defines what constitutes a real financial crises in much broader terms. In this view, financial crises either involve sharp declines in asset prices, failures of both large financial and non-financial firms, deflation or disinflation, disruptions in foreign exchange markets, or some combination of all of these.

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The problem with the monetarist view of financial crises is that it is extremely narrow, focusing exclusively on bank panics and their affect on the money supply. At the same time, the more traditional definition is too broad and imprecise.

However, in recent years, the asymmetric information analysis which has been applied in order to understand the structure of the financial system and the rationale for bank regulation has also been used to develop a theory of banking and financial crises.

To understand this analysis we must look at what banks do. The business concept is based largely on the banks' ability to reduce the uncertainty about borrowers and their chances of meeting commitments. Sound borrowers must first be distinguished from others, followed by continuous monitoring of well-founded credit assessments.

The problem is that a borrower usually has better information about the potential returns and risks associated with his planned investment projects than does the lender. Asymmetric information creates problems in the financial system in two basic ways: before and after the transaction has been executed. In order to do a proper job of screening good borrowers from bad, banks need a stable environment in the economy and in financial markets. Any negative effects of the existence of asymmetric information can also be limited by the banks requiring collateral for the loans they do provide.

If banks cease to be able to reduce the uncertainty associated with the lending process and improve, or make up for, the asymmetric information, then they may refrain from providing credits. In such a situation banks may simply no longer be in a position to distinguish between good and bad borrowers and therefore could stop lending at all. This cuts off the economy's supply of liquidity and hits lending to consumers and investors as well as to other banks. A contraction of the credit supply—a credit crunch—arises and may have contagious effects on the real economy, in that consumers and firms can no longer obtain the credits their plans require. GDP falls and unemployment rises.

This analysis suggests that, in order to define a financial crisis we should look for events in the economy that make the screening process difficult for banks. Such events could be sharp declines or surges in asset prices, sharp swings in market interest rates and major failures of non-financial institutions. But of course, not all declines in asset prices or increases in interest rates constitute real financial crises.

We need additional information to help detect a situation where banks have difficulties in distinguishing between good and bad borrowers and therefore have a tendency to cut down their lending activities. One such signal is the spread between interest rates for low and high-quality borrowers. In a situation where banks experience difficulties in distinguishing between good and bad borrowers, one should expect a rise in interest rates to borrowers about whom it is genuinely difficult to obtain reliable information.

This is precisely what we have seen in various segments of financial markets this autumn, not least the rate spreads between sovereign debt in industrial countries and in emerging markets. But many other spreads between interest rates for high and low-quality borrowers have also been rising and that has been a source of serious concern for policy makers all over the world.

Spreads were also high during the Swedish crisis in the early 1990s. While the current high spreads seem to be exaggerated, I should like to point out that the earlier spreads may have been too low, not reflecting actual risk.

The Swedish crisis - what happened?

Let me now turn to the Swedish crisis in the early 1990s. The economic problems in Sweden should be seen in their historical context. For several reasons, economic growth in Sweden had been relatively weak ever since the beginning of the 1970s. Following the collapse of the Bretton Woods system, the creation of a stable macroeconomic environment turned out to be difficult. Wage formation functioned badly, fiscal policy was unduly weak and in addition structural problems were gradually making more and more of an impact.

Credit market deregulation during the first half of the 1980s, necessary in itself, meant that monetary conditions became more expansionary. This coincided, moreover, with an already rising level of economic activity and relatively high inflation expectations. In the absence of a more restrictive economic policy to parry all this, the freer credit market led to a rapidly growing stock of private sector debt, of which a large part was short-term debt in foreign currency channelled through the banking system. Real aggregate asset prices increased substantially. A speculative bubble was generated.

Step by step the Swedish economy became increasingly vulnerable to shocks. During 1990 matters came to a head. Competitiveness had been eroded by the relatively high inflation in the late 1980s, resulting in an overvalued currency. This caused exports to weaken and meant that the fixed exchange rate policy began to be questioned, leading to periods with relatively high nominal interest rates. Asset prices began to fall and economic activity turned downwards. A tidal wave of bankruptcies was a heavy blow to the banking sector. Various spreads between interest rates for low and high-quality borrowers had been rising. Accordingly, signs of a real financial crises were emerging.

Management of the crisis

When a serious financial crisis threatens to develop it is important both to avoid a widespread failure of banks and to bring about a macroeconomic stabilisation. The two are interdependent. A collapse of much of the banking system would aggravate the macroeconomic situation, just as failure to stabilise the economy would accentuate the banking crisis. Accordingly, this requires both macroeconomic measures and measures to maintain the banking system's solvency and liquidity in order to prevent large segments of the banking system from failing on account of acute financing problems.

In September 1992 the Government and the Opposition jointly announced a general guarantee for the obligations of the whole of the banking system. This broad political consensus was, I believe, of vital importance and made the prompt handling of the financial crisis possible.

The bank guarantee provided protection from losses for all creditors except shareholders. The Government's mandate from Parliament was not restricted to a specific sum and its hands were also very free in other respects. This necessitated close co-operation with the political opposition in the actual management of the banking problems.

The decision was of course troublesome and far-reaching. Besides involving difficult considerations having to do, for example, with the cost to the public sector, it raised such questions as the risk of moral hazard. However, the political system concluded that in the event of widespread failures in the banking system, the Swedish economy would suffer major repercussions. There was simply no choice. One way of limiting moral hazard problems was to engage in tough negotiations with the banks that needed support and to enforce the principle that losses were to be covered in the first place with the capital provided by shareholders.

A separate authority, the Bank Support Authority, was set up to administer the bank guarantee and manage the banks that landed in a crisis and faced problems with solvency, though the crucial decisions about the provision of support were ultimately a matter for the Government.

It was up to the central bank to supply liquidity on a relatively large scale at normal interest and repayment terms but not to solve problems of bank solvency. Collateral was not required for the loans to banks, neither intraday nor overnight. The banking system was free to obtain unlimited liquidity by drawing on its accounts with the central bank.

The bank guarantee meant that the solvency of the central bank was not at risk. In order to offset the loss of credit lines in foreign currency to Swedish banks, during the height of the crisis the Riksbank also lent large amounts in foreign currency. Thus, the central bank assumed the role of provider of liquidity, not only in domestic currency but also in foreign currency.

Banks applying for support had their assets valued by the Bank Support Authority, using uniform criteria. The banks were then divided into categories, depending on whether they were judged to have only temporary problems as opposed to no prospect of becoming viable. Knowledge of the appropriate procedures was built up by degrees, not least with the assistance of people with experience of banking problems in other countries.

The Swedish Bank Support Authority chose to disclose expected loan losses and to assign realistic values to real estate and other assets. This method was consistent

with other basic principles for the bank support, such as the need to restore confidence.

Since the acute crisis had been triggered by difficulties in obtaining international finance, great pains were taken to give a transparent picture of how the crisis was being managed so as to gain the confidence of Sweden's creditors. This applied both to the account of the magnitude of the banking problems and to the content of the bank guarantee. Various informative projects were arranged for this purpose throughout the world. In Sweden, too, considerable efforts were made to legitimise the measures and their costs.

The banking problems did arouse a lively debate in Swedish society but the work could still be done in broad political consensus, which was a great advantage. The bank guarantee was terminated in 1996 and replaced with a deposit guarantee that is financed entirely by the banks.

With regard to macroeconomic policy, the following could be said. In the early stage of the crisis, the automatic stabilisers in the government budget probably helped to lessen the contraction of GDP. This meant that business profits and household disposable income were sustained relatively well. But it also entailed, after a while, a massive increase in the budget deficit and this in turn generated new problems, which of course had to be tackled when the acute crisis was over.

Furthermore, monetary conditions were given a stimulatory turn. That also helped to stabilise both the economy and the banking system. Lower market rates eased the fall in asset prices, lightened the burden of servicing private sector debt and mitigated the negative impact on the financial system.

Rescuing the banking sector was necessary to avoid a collapse of the real economy. But it was also necessary to stabilise the economy directly through macroeconomic measures.

Similarities with other countries experiencing financial crises

There are several aspects of the build-up to the crisis in the Swedish case that are worth highlighting and that were similar to the situation in Southeast Asian countries. Current-account deficits had been financed with short-term loans mediated via the banking system in connection with rapidly growing credit. Weakening economic activity, falling asset prices and rising lending losses eroded confidence in the banking system and spread uncertainty among foreign creditors. This resulted in tendencies towards a shortage of foreign liquidity in the banking system, capital outflows and downward pressure on exchange rates.

The lender of last resort mechanism depends on the ability of the central bank to provide sufficient liquidity to the banks. However, when the liquidity needs are in foreign currency, the central bank may be unable to fulfil its role as lender of last resort due to a lack of adequate foreign reserves. This could lead to the threat of an outright default for the whole banking system and a severe financial crises. The Swedish central bank managed to provide the banking system with liquidity in

foreign currency. This was not the case to the same extent in Southeast Asia. Thus, the crisis developed differently in those countries. They had to turn to the International Monetary Found for assistance.

One important factor that stimulates short-term capital inflow is a fixed exchange rate regime. Both Sweden and the countries in Southeast Asia had fixed exchange rate regimes at the time of the build-up to the crisis. Fixed exchange rate regimes mean that the central bank seemingly absorbs the risks of exchange rate movements on behalf of the investors, which tends to encourage capital inflows, especially with short-term maturity. But should the currency have to depreciate, large credit losses will affect the banks.

Conclusions

Allow me now to summarise what I consider to be the most important lessons of a financial crisis:

1. Prevent the conditions for a financial crisis

The primary conclusion from the experience of financial crisis is, of course, that various steps should be taken to ensure that the conditions for a financial crisis do not arise.

- Fundamentally, this is a matter of conducting a credible *economic policy focused on price stability.* This provides the prerequisites for a monetary policy reaction to excessive increases in asset prices and credit stocks that would be liable to boost inflation and avoids the type of speculative climate that paves the way to a financial crisis. In this respect a floating exchange rate regime is helpful in that it gives monetary policy an active roll. In contrast to a fixed exchange rate regime, it does not encourage the inflow of short-term and volatile capital by the central bank absorbing the exchange rate risk.

- Looking back, it can be said that if *various indicators* that commonly form the background to a financial crisis had been followed systematically, then incipient problems could have been detected early on. That in turn could have influenced the conduct of economic policy so that Sweden's financial crisis was contained or even prevented.

- In Sweden's case the *supervisory authority* was not prepared for the new environment that emerged after credit market deregulation. The lesson from this is that much must be required of a supervisor operating in an environment characterised by deregulated markets.

2. If a financial crisis does occur

In a sense all major financial crises are unique and therefore difficult to avoid or prepare for. Once a crisis is about to develop, however, there are some important lessons to learn concerning its handling.

- If an economy is hit by a financial crisis, the first important step is to *maintain liquidity in the banking system* and prevent *the banking system from collapsing*. For the management of Sweden's banking crisis, the political consensus was of major importance for the payment system's credibility among the Swedish public as well as among the banking system's creditors throughout the world.

- The prompt and transparent handling of banking sector problems is also important. The terms for recapitalisation should be such as to avoid moral hazard problems.

- It is important both to avoid a widespread failure of banks and to bring about macroeconomic stabilisation. *The two are interdependent.* The collapse of much of the banking system would aggravate the macroeconomic weaknesses, just as failure to stabilise the economy would accentuate the banking crisis.