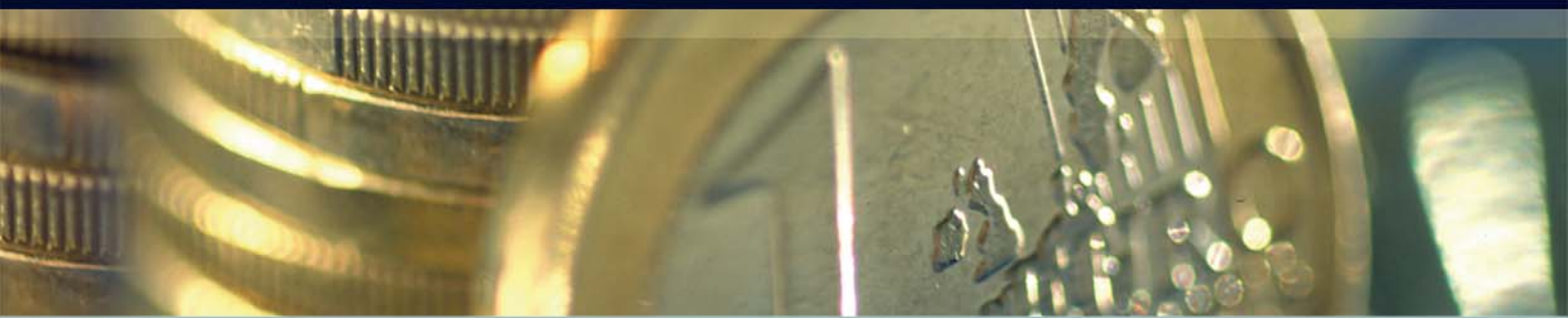


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The Swedish model for resolving the banking crisis of 1991-93. Seven reasons why it was successful

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***The Swedish model for resolving the banking crisis of 1991-93.
Seven reasons why it was successful***

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Abstract: This study presents the main features of the Swedish approach for resolving the banking crisis of 1991-93 by condensing them into seven policy lessons. These concern (1) the importance of political unity behind the resolution policy, (2) a government blanket guarantee of the financial obligations of the banking system, (3) swift policy action where acting early was more important than acting in exactly the right manner, (4) an adequate legal and institutional framework for the resolution procedures including open-ended public funding, (5) full disclosure of information by the parties involved, (6) a differentiated resolution policy minimizing moral hazard by forcing private sector participants to absorb losses before government financial intervention, and (7) the proper design of macroeconomic policies to simultaneously end the crisis in both the real economy and the financial sector.

The exportability of the Swedish model of the 1990s to countries suffering from financial turmoil today requires a detailed knowledge of the institutions, legislation and political conditions in the country involved. The application of these lessons outside Sweden is not a simple task, given the major differences between the initial conditions of the Swedish crisis of the early 1990s and the present global financial crisis. Nevertheless, the Swedish experience of bank resolution does provide important lessons for today.

Key words: Financial crisis, bank resolution, solvency crisis, banking crisis, Sweden.

JEL classification: E44, G14, G21, G28, G32, G33.

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The Swedish model for resolving the banking crisis of 1991-93. Seven reasons why it was successful

Introduction¹

The present financial turmoil has focused interest on the experience of how financial crises were managed in the past. The Swedish bank resolution policy in the early 1990s has attracted considerable international attention, as it is commonly regarded as successful. The purpose of this paper is to present the main features of the Swedish model for resolving the banking crisis of 1992-95 by condensing them into seven major policy-lessons.

This paper is structured as follows. First, an account of the Swedish financial crisis is given to serve as background for the actions taken to salvage the banking system. Secondly, the main features of the bank resolution policy are presented in condensed form. Thirdly, the bank resolution policy is briefly evaluated. In the fourth and final section, the relevance of the Swedish experience for other countries is considered by making a comparison between the Swedish banking crisis of the early 1990s and the current global financial crisis. The paper concludes with a summary.

1. The anatomy of the financial crisis of the early 1990s²

The Swedish banking crisis was part of a major crisis that hit the Swedish economy in 1991-92. The main impulse driving the boom-bust, which ended in a deep crisis, is found in the process of financial liberalization. The main deregulatory measure was taken in November 1985, which was when the quantitative restrictions on the volume of bank lending were

¹ This paper has benefited significantly from constructive comments by Emil Ems and Göran Lind, who dealt with bank resolution policies in the *Riksbank* during the 1991-93 financial crisis. Magnus Astberg, Lars Heikensten, Andrea Schaechter, Garry Schinasi, Elemer Tertak, Gabriel Urwitz, Claes Wihlborg and Lars Wohlin have given valuable suggestions. The author's experience as chief economic advisor to prime minister Carl Bildt in 1992-94 is a source of inspiration for this paper.

² This section is based on several studies, among others Drees and Pazarbasioglu (1998), Englund (1999), Englund and Vihriälä (2009), Jonung (2008) and Jonung, Kiander and Vartia (2009).

abolished. At that time, the Swedish currency, the *krona*, was pegged to a basket of foreign currencies.

Financial liberalization fundamentally affected the incentives of lenders and borrowers. After decades of non-price credit rationing, when interest rates were set below market rates and credit was allocated according to political preferences, commercial banks and savings banks were suddenly able to expand their lending without being hampered by regulatory restrictions. They entered into a fierce competition for market shares by freely offering loans to households and firms.

A lending boom started in 1985-86, channeling credit to asset markets - primarily to housing, as well as to commercial real estate and to the stock market. The process was fuelled by rising inflation and a tax system that favored borrowing, resulting in negative real after-tax rates. As a result, there was a rapid increase in asset prices. They formed the basis for rising collateral values and the increasing net wealth of households, further fuelling the credit expansion. Within a couple of years, the aggregate credit volume had increased at an unprecedented speed.

These financial developments impacted on the real economy. The macroeconomic outcome was a strong boom in 1988-89, characterized by overfull employment, rising consumption and falling private savings ratios, which eventually turned negative. The current account balance worsened as export performance weakened and imports rose.

Due to the pegged exchange rate for the *krona*, monetary policy was prevented from mitigating the boom through interest rate increases. Fiscal policies were not sufficiently tightened to arrest the boom, although national budgets posted large surpluses due to rising tax revenues from higher consumption, wages, property values and capital gains.

The boom in the real economy was eventually halted in 1989-90 and turned into a bust as a result of a combination of events, both international and domestic. Real interest rates rose internationally as a result of the contractionary German monetary policy following German reunification. Rising German interest rates exerted strong upward pressure on Swedish interest rates, as the *krona* was pegged to the *ecu* - the virtual European currency unit - in May 1991. An additional real interest rate shock emerged when the Swedish central bank, the

Riksbank, raised nominal interest rates to defend the pegged *krona* rates against recurring speculative attacks in 1989-92.

Other policy measures increased the real after-tax interest rate. The far-reaching tax reform of 1990-91, dubbed “the tax reform of the century”, significantly lowered marginal taxes and reduced the tax deductibility of mortgage rates, in this way raising real after-tax interest rates. Consequently, borrowing became less attractive, while private savings became more attractive. A rapid and not altogether expected decline in the rate of consumer price inflation in 1990-92 contributed to the sharp rise in real interest rates. Within a couple of years, real after-tax interest rates rose to levels that were much higher than borrowers had anticipated a few years earlier – for many households from about minus 5 per cent to more than plus 5 per cent.

This sharp increase in the real interest rate had a profound impact on financial markets. Asset price deflation surfaced when the value of real assets was reduced by rising real interest rates. Balance sheets turned fragile when asset values, primarily property prices, fell below collateral values. At the same time, the nominal values of debt remained unchanged. Wealth losses came to the fore, forcing an adjustment of portfolios, which led to falling private consumption, falling investments and rising private savings.

The harder households and firms tried to improve their wealth position by selling assets and increasing savings, the deeper the crisis became. The sell-out of property forced down property prices which, in turn, triggered new sales. The number of bankruptcies increased at a dramatic rate. Stock market prices tumbled, in particular for firms engaged in the financial sector, in real estate and in construction.

Investments fell, particularly in the construction sector. With prices for existing houses declining, demand for new construction evaporated. Unemployment soared. As the Swedish *krona* was overvalued due to high wage and price inflation during the preceding boom, the export sector encountered major problems in 1990-91. Tax revenues declined and public expenditures rose due to the workings of automatic stabilizers. The government budget deficit, and thus the ratio of government debt to GDP, increased dramatically.

In the autumn of 1992, Sweden's financial system was rocked when the Swedish *krona* was exposed to major speculative attacks. The *Riksbank* vigorously defended the peg with high overnight rates. For a very brief period in September the overnight rate was 500 percent. The defence of the peg by the *Riksbank* was supported by a set of "crisis packages", or fiscal austerity measures, presented jointly by the Centre-Right government and the Social Democratic opposition.

The Swedish policy to maintain the pegged *krona* rate attracted international attention. No other country showed such determination to keep its exchange rate pegged. Many currencies with a pegged rate were victims of speculative attacks in September 1992. Great Britain, Italy and Finland all caved in and were forced to adopt a floating exchange rate, while Sweden managed to stay on its peg.

Why was the pegged exchange rate of the *krona* so vigorously defended by the Swedish political establishment in autumn 1992? This policy is best explained by the lessons that economists and politicians drew from the devaluations of the *krona* - five in total - during the second half of the 1970s and the early 1980s. The common opinion among both economists and policy-makers was that these devaluations had not resolved the long-run economic problems, but merely concealed them in the short run, while leading the Swedish economy into a process of devaluation cycles. A hard currency policy based on a firm peg was seen as the proper strategy of breaking with the devaluations of the past. The idea was that the pegged rate should act as the nominal anchor for stabilization policies and serve as a means to achieve low inflation and thus create a proper climate for growth and employment.³

The general ignorance of the workings of financial markets, of the role of portfolio imbalances and of boom-bust patterns is an additional reason why the pegged exchange rate was defended so energetically. Policy-makers and economists in Sweden did not understand that the financial deregulation of the 1980s fundamentally changed the prerequisites for the pegged exchange rate policy as it allowed for speculative capital flows. The crisis therefore

³ See Jonung (2008) and Jonung, Kiander and Vartia (2009) on the debate on the choice of exchange rate regime for Sweden in the 1980s.

came as a complete surprise to policy-makers, economists, financial market actors and the public alike.⁴

The defence of the *krona* lasted until November 19, 1992, when speculative attacks forced the *Riksbank* to let the *krona* float. The floating of the *krona*, with the ensuing depreciation and receding domestic interest rates, halted the downturn of the Swedish economy. The recovery began in 1993 and lasted for more than a decade. The main engine behind the recovery was an impressive growth in exports.

Compared to the record of all major crises in Swedish economic history, the crisis of the 1990s was one of the most costly in terms of output, industrial production and employment foregone. Only the crisis of the 1930s caused a bigger loss in real income than the crisis of the 1990s. Employment was particularly hard hit during the 1990s. The cumulative employment loss is the largest on record – higher than during the Great Depression of the 1930s.⁵

The crisis undermined the financial system and threatened the existence of major banks. This forced the government to act, thus laying the foundations for the Swedish model of bank resolution policy.⁶

2. The Swedish model for bank resolution

The approach used by the Swedish authorities developed piecemeal. There was no grand scheme available before the banking and currency crisis of the early 1990s. Initially, most measures were taken on an *ad hoc* basis. Eventually, as the crisis started to emerge as a major threat to the economy, policy-makers were forced to respond in a more consistent manner. This process developed into the Swedish model for bank resolution.

⁴ This is seen from the memoirs of several policy-makers, most prominently by Bengt Dennis, governor of the *Riksbank* 1982-1994. See Dennis (1998). See also Jennergren (2002) and Jonung, Kiander and Vartia (2009) on the reasons why financial market participants and policy-makers did not respond to the asset boom until it was too late.

⁵ See Jonung and Hagberg (2009).

⁶ Sweden's neighbours Finland and Norway were hit by financial crisis roughly at the same time as Sweden, triggering government measures to salvage the financial system. These steps, some of which were similar to those taken in Sweden, did not attract the same international interest as the Swedish bank resolution policy. See Englund and Vihriälä (2009) for Finland and Steigum (2009) for Norway.

In retrospect, the Swedish model for bank resolution consisted of several features. We can regard the core of the model as comprising the following seven elements.⁷

1. 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.

The leadership of both political camps knew that behind the crisis lay a legacy of policy measures taken by two successive governments, first by the Social Democratic government of 1982-91 that initiated the financial deregulation in the mid-1980s and subsequently introduced policy changes that caused the sharp increase in real interest rates and, secondly, by the Centre-Right government that came into power in the election of autumn 1991, inheriting both the financial imbalances of the boom years and the ensuing bust and emerging depression.

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.

2. 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

⁷ The following account is based on among others Andersson and Viotti (1999), Berg (1998), Bäckström (1997), Dennis (1998), Englund (1999), Englund and Vihriälä (2009), Heikensten (1998a and b) and Ingves and Lind (1996, 1998 and 2008) and Lundgren (1998).

protected from any future losses on their claims. According to the press release, the government was going to ask the parliament, the *Riksdag*, to agree on a complete legislation package later that autumn to address the financial turmoil. An outline of the expected measures was included in the press release. See Appendix 1 for the English version of the press release.

The press release declared that the purpose of the blanket guarantee was that "households, enterprises and other holders of claims can feel secure" (see Appendix 1). However, the immediate reason for the press release was actually the fear of losing foreign financing facilities. Swedish banks were heavily dependent on foreign financing of their activities. Short-term foreign borrowing represented about 40 per cent of total bank borrowing. If this funding were to dry up, it would not be possible for the *Riksbank* to maintain the pegged *krona* rate.⁸

For the policy-makers there was no alternative but to issue a blanket guarantee to support the *krona*. In the currency turmoil, where speculation had forced the central banks of the United Kingdom, Finland and Spain, among others, to let their currencies float, the peg of the *krona* came under heavy speculative pressure. The blanket guarantee - already a drastic measure in itself - was thus an attempt to eliminate foreign fears that Swedish commercial banks would not be able to meet their financial obligations. The guarantee was successful in the sense that foreign confidence in the solvency of the Swedish commercial banks remained intact.

In addition, this stop-gap measure proved highly beneficial, as it expanded the options for the *Riksbank* to support banks regardless of their financial position. Through the press release, the *Riksbank* was given the option to lend to any commercial bank operating in Sweden, even to those that were on the brink of insolvency, because the press release represented a State guarantee for the liabilities of the banks.

In short, 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

⁸ The government, through the National Debt Office, was prohibited to carry out any foreign net borrowing. This policy (*valutalånenormen*), launched in 1984, contributed to the private sector entering rapidly into foreign debt after the financial liberalization during the second half of the 1980s.

banking system.⁹ Bearing in mind that Sweden is a small, open economy, access to international financing was crucial after the abolishment of capital account controls in 1989.

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 confidence throughout the resolution of the crisis at a relatively low political cost. Swift action kept any uncertainty regarding policy measures to a minimum.

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.”

4. An adequate legal and institutional framework based on open-ended funding

In December 1992, the Swedish Parliament, the *Riksdag*, passed legislation by an overwhelming majority and with no political infighting to establish a Bank Support Authority, *Bankstödsnämnd*, 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 now turned into a more systemic approach.

The parliament decided that the *Bankstödsnämnd* 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 *Bankstödsnämnd* would be forced to go back to the *Riksdag* to ask for additional funding at a

⁹ A blanket guarantee per se by the government is not a sufficient criterion for success. Such guarantees may involve moral hazard and undesirable effects on competition. See Laeven and Valencia (2008b) for a survey of the use of blanket guarantees in banking crises.

later stage.¹⁰ 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 *Bankstödsnämnd* was set up as an independent agency at a distance from the government, the *Riksbank* and the *Finansinspektion* (the financial supervisory authority). This construction fostered credibility and trust in its operations. The Social Democratic opposition was given full insight into its activities. It was staffed by professionals and it began operation in the spring of 1993, shortly after it was established.¹¹ It worked closely with the *Riksbank*, the *Finansinspektion* and the National Debt Office. In the few cases when these institutions were not in agreement, the Ministry of Finance acted as arbitrator.¹²

Through this legislation, the bank resolution policy was based on appropriate institutional framework and on open-ended funding. This was key to the success of the resolution policy.

5. Full information disclosure

From the very start, the *Bankstödsnämnd* sought to obtain a clear picture of the financial problems facing the financial institutions through due diligence. Even before it began its work, and in its early stages, 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 *Bankstödsnämnd* with requests for support were obliged to give full disclosure of all their financial positions, opening their books completely to scrutiny. This requirement facilitated the resolution policy, as well as making it acceptable in the eyes of the public.

¹⁰ Here the experience of Finland served as a warning. The Finnish parliament had first settled for a limit to its bank support, which had to be revised later - at considerable political cost.

¹¹ Foreign firms like Arthur Andersen, McKinsey and Credit Suisse First Boston served as advisers to the Ministry of Finance and the *Bankstödsnämnd*. See Ingves and Lind (1998).

¹² See Ingves and Lind (2008).

6. Differentiated resolution policy to maintain the banking system and prevent moral hazard

Banks that turned to the *Bankstödsnämnd* 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 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 *Bankstödsnämnd*.

Category 1. The *Bankstödsnämnd* encouraged these institutions to find private sector solutions and to avoid public involvement as far as possible.¹³ Shareholders were requested to inject additional capital where such an option was feasible. To facilitate this process, the *Bankstödsnämnd* was prepared to grant a temporary “capital adequacy” guarantee. Only one bank, *Handelsbanken*, turned out not to need an injection of capital. Another bank, *Skandinaviska Enskilda Banken*, chose to reinforce its capital base through a share issue aimed at its current shareholders, without having to apply for any public guarantees.

Category 2. This category covered a bank with short-term problems, but with a good prospect of future profits that could be expected to restore solvency. In such cases, where private solutions may not be available, the *Bankstödsnämnd* was prepared to deploy more extensive support, including capital contributions or loans, in addition to the guarantee mentioned in category 1. *Föreningsbanken* was dealt with under this category, receiving a guarantee that the State would contribute share capital in case the capital adequacy ratio fell below 9 per cent. This guarantee proved not to be needed.¹⁴

¹³ As part of the encouragement it was made clear to them that public involvement may necessitate an initial adjustment of private shareholder capital.

¹⁴ See Ingves and Lind (1998).

Category 3. This category embraced banks that were not expected to become profitable; their equity would gradually erode and ultimately become negative. This category required active State involvement, ultimately in the form of orderly liquidation of the ailing institution. However, if a more favourable result could be achieved with other methods, the *Bankstödsnämnd* was entitled to apply those as well, for instance by selling bad assets and consolidating the remainder of the bank, either on its own or through a merger with other banks. Such an approach was adopted in the case of two major insolvent banks, *Nordbanken* and *Gotabanken*.¹⁵

Two bank asset management corporations (AMCs), *Securum* for *Nordbanken* and *Retriva* for *Gotabanken*, were set up to manage the bad debt (non-performing loans) of these two 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*.¹⁶ 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.¹⁷

In the long run, about 10-15 years, 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 by the revenues received through the liquidation of the asset holdings of the bank asset management corporations.

7. The role of macroeconomic policies to end the crisis

The bank resolution policy in Sweden was much facilitated by the design of monetary and fiscal policies to counteract the crisis once it peaked in the autumn of 1992. These measures allowed the Swedish economy, and hence the financial system, to recover fairly rapidly.

¹⁵ The deposits of the *Gotabanken* and the *Nordbanken* represented roughly 20 per cent of all deposits.

¹⁶ See Bergström, Englund and Thorell (2002) and Heikensten (1998a and b).

¹⁷ This is in sharp contrast to the Japanese policy of setting high values for "bad" assets, thus freezing the real estate market for about a decade.

The fall of the pegged exchange rate of the *krona* on November 19, 1992 due to speculative attacks turned out to be an important move towards the recovery. This step was initially seen as a failure, indicating that the *Riksbank* and the government were unable to stick to the declared hard currency policy. Once the *krona* was floating, it depreciated sharply - by nearly 30 per cent. The depreciation turned out to be long-lasting, to the surprise of economists who had expected a return of the pattern of previous devaluations of the *krona* when domestic price and wage increases eliminated in a few years the gain in competitiveness from the devaluations.

The depreciation was the main driving force behind the recovery which started shortly thereafter in 1993. In the years that followed, exports became the engine of the Swedish economy. Between 1992 and 2008, exports roughly doubled as a share of GDP. There is no other period of similar positive export performance in Swedish economic history. Sweden's growth rate remained above the EU average for many years after the crisis.

Once the *krona* was floating, monetary policy was able to focus on domestic conditions. The *Riksbank* declared an inflation target in January 1993 to be valid from 1995. 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.

Fiscal policies were supportive too. The government allowed budget surpluses to accumulate during the run-up to the crisis and huge deficits to develop during the crisis, mainly as a result of the workings of automatic stabilizers. Figure 1 demonstrates that the boom in 1987-1990 was associated with a budget surplus of around 4 per cent of GDP. This turned into a large and lasting deficit during the bust in 1991-97, peaking at almost 12 percent of GDP in 1993. The bank support policy was allowed to contribute to the rise in the deficit.¹⁸ Viewed in an international context, see the budget deficit of the EA 12 in Figure 1, the development of the Swedish budget deficit was extraordinary, characterized by large amplitude.

¹⁸ The role of fiscal policy during the crisis is a contested issue. See Jonung (2008).

In short, the rapid recovery of the Swedish economy greatly facilitated the bank resolution policy. As soon as the economy was expanding, pressure on the banking system started to lessen. Balance sheets were strengthened. The banking system became profitable again.¹⁹

3. Evaluating the Swedish bank resolution

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.²⁰ 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, and the banking system was swift to move out of the crisis. The banking system remained largely privately owned and became profitable shortly after the crisis.²¹

The exceptions to this rosy picture are *Nordbanken* and *Gotabanken*. *Nordbanken*, previously a government-owned bank that was partially privatized (25 per cent) in the late 1980s, was re-nationalized. *Gotabanken* was taken over by the Government and amalgamated with the former *Nordbanken* after the default of the bank holding company, *Gota AB*. However, the consolidated *Nordbanken* was eventually privatized and emerged as a successful venture in the form of *Nordea*, now the only true pan-Nordic bank currently active in Denmark, Finland, Norway and Sweden.

Another reason for taking a positive view of the Swedish approach is that the net fiscal cost, more commonly referred to as the 'cost to the taxpayer', turned out to be very low or even positive in the long run.²² Figure 2, displaying the net fiscal costs for 39 systemic banking crises in the world in the period 1970-2007, demonstrates that Sweden ranks favourably with a net fiscal cost of close to zero. The gross fiscal cost for the bank support policy amounted to 3.6 per cent of GDP initially.²³ By now, some 15 years after the crisis, the cost to the

¹⁹ See Englund and Vihriälä (2009).

²⁰ For positive assessments of the Swedish bank resolution approach, see among others Ergungor (2008). See also Calomiris, Klingebiel and Laeven (2004) for a survey of alternative crisis resolution policies, although these authors draw no firm conclusions about the optimum design of resolution policies.

²¹ The Swedish record looks attractive compared to that of Japan, where the banking system remained in distress for a much longer period than in Sweden.

²² The cost to society in terms of lost output, industrial production foregone and loss of employment was huge. See the summary in Jonung and Hagberg (2009).

²³ Data on gross and net fiscal costs are taken from Laeven and Valencia (2008a).

taxpayers is likely to have been repaid after the liquidation of the assets that were taken over by government institutions. The best estimate available, at least so far, suggests that the fiscal outlays for supporting the banking sector were recovered.²⁴ However, there is no official estimate of the ultimate fiscal cost of the bank support policy to the taxpayer.

The Swedish crisis management was also a domestic affair. No international organizations like the IMF were involved which probably contributed to public trust in the process.²⁵

Nevertheless, mistakes were made along the way, although these have not received as much attention as the policy successes. For example, the Financial Supervisory Authority (*Finansinspektionen*) tightened the accounting rules as the crisis evolved, putting additional pressure on the banking system.²⁶ Complaints were made that firms with a good credit record were transferred to AMCs, thus left without an ordinary bank connection.²⁷ However, these mistakes are minor in comparison to the positive effect of the overall policy of managing the financial crisis.

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.

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 that fuelled rapid increases in asset prices, in particular house prices. The boom was supported by lax monetary and fiscal policies. The

²⁴ The most complete and updated attempt to evaluate the cost and returns to the taxpayers is presented by Christner and Hagbjer (2007). Building on the work by Jennergren and Näslund (1998), they take the support paid by the government during the acute phase of the crisis as a starting point and then estimate the revenues from the selling of the "bad" assets taken over by the government. They conclude that "the Swedish government has neither lost nor gained any significant amount from the subsidies" once given to the banking system.

²⁵ IMF took indirectly a part in the policy of defending the peg for the *krona* in 1992 by recommending budget consolidation. See Dennis (1998, p. 64) and Jonung (2008).

²⁶ See Urwitz (1998, p. 63). The changes in the rules were reasonable per se. The problem was that the evaluation methods should have been changed before, not during, the crisis.

²⁷ Representatives from small business also complained that commercial banks unduly cut off credit to viable firms forcing unnecessary bankruptcies and forced sales.

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. The financial crisis impacted on the real economy, initiating a deep recession.

On the other hand, there are also 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.

Sweden, being a small open economy with a pegged exchange rate when the crisis peaked, was able to abandon the pegged rate in November 1992, thus obtaining a significant and lasting depreciation of its currency that contributed to a strong and prolonged recovery out of the crisis. This 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.

The small size of the Swedish financial system in the 1990s facilitated the bank resolution policy. Policy-makers had to deal 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

and where public trust in the financial system and its actors (“Wall Street”) is extremely low.²⁸

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, 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.

In short, the Swedish financial system was much more transparent than is currently the case in most countries. Now, the lack of transparency has prevented the rise of a properly functioning interbank market, giving rise to large interbank spreads and a liquidity crisis, in spite of various government guarantees in several countries. A liquidity crisis of this type did not emerge in Sweden in the early 1990s, because the banking system remained transparent thanks to the work of the *Bankstödsnämnd*.

The ongoing global crisis is a banking crisis as well as a financial market crisis, by contrast with the Swedish crisis, which was primarily a banking crisis, and only later became a currency crisis – thus turning into a “traditional” twin crisis when the *krona* came under attack by speculators. 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, like General Electric and other companies that rely heavily on the commercial paper market, 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.

Indeed, on this score, the ongoing crisis has been difficult for the authorities to manage, in part because some traditional central banking tools – particularly in the United Kingdom and the United States – are not well suited, either legally or architecturally, to provide liquidity for

²⁸ Wages and bonuses paid to bankers created a public outcry in Sweden as well in the 1990s, thus becoming a problem for policy-makers during the management of the financial crisis. Several attempts were made by the government to recover remuneration paid out by *Nordbanken*, but failed. See Lundgren (1998, p. 11).

the institutions most in need, including investment banks and insurance companies. In the event, authorities had to innovate in order to provide large amounts of liquidity, but were unable to immediately restore trust and confidence to major market participants. By contrast, the Swedish blanket guarantee of September 1992 immediately created trust; one reason for this was the comparatively simple set of instruments available compared to the present case.

In addition, Sweden has a long tradition of confidence in its domestic institutions, in its political system and in its elected representatives.²⁹ 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 and costly decisions to the public and to be trusted. Trust contributed to the belief that the *Bankstödsnämnd* 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.

The financial crisis hit Sweden in September 1992 – less than a year after the election in October 1991. As the next election was due to take place in October 1994, politicians were probably more inclined to cooperate across the standard political divides than in the case of an immediate election as in the fall of 2008 in the US.

Today, as a result of the global financial crisis, there is much more genuine uncertainty about the international financial architecture, about the regulation of the financial system and about the proper strategy for central banking than was the case in the early 1990s. The Swedish policy-makers of yesterday designed their bank resolution policies in a more stable macroeconomic and financial global setting.

The above account of the differences between Sweden in the early 1990s and the global situation today suggests that it was far easier for policy-makers to deal with a local financial crisis in a small open economy like Sweden's in the past than it is today to manage a global crisis characterised by strong and sophisticated financial and economic cross-border links. The international financial linkages suggest a need for international cooperation, in particular

²⁹ The strong role of public trust in Sweden compared to the case of East Asia during the banking crises of the 1990s is highlighted by Kokko and Suzuki (2009).

within the EU. Although policy-makers trying to support the financial system today are facing greater challenges, the Swedish model of bank resolution can nevertheless serve as a source of inspiration – indeed as a benchmark or template – for countries facing financial crisis.

5. Summary

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 public 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. The policy of public support should be designed such that is perceived as efficient, fair and just by the public. Once the public believes that the financial system is stabilized, trust will return.

In short, the task of government, or - in popular terms - the task of the taxpayer, should be to serve as the capitalist or investor of last resort in order to rescue the financial system, thus preventing the financial breakdown from having severe and lasting effects on the real economy. In addition, trust is also based on the general performance of the real economy. Saving the financial system should be carried out at the same time as policies are in place to improve overall economic conditions.

The approach adopted to address the solvency issue during financial crises differs from one crisis-hit country to another. In the early 1990s, the Swedish government designed an approach that drew plaudits. The conclusions from the Swedish experience for other countries facing a banking crisis must be that the process of support to the financial system would gain from having a basis of political unity, speed and transparency. It should minimize moral hazard by being implemented within an open, consistent and all-encompassing strategy, and have 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 authority. The 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. The 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.

These conclusions from the Swedish case are easy to summarize. However, when exporting them to other countries, attention should be paid to differences in initial conditions. A detailed knowledge of institutions, legislation and political conditions in the country involved is needed. The Swedish model of bank resolution can be used as a general template for countries facing financial crisis, but these countries will need to adapt the details of the implementation to their own circumstances

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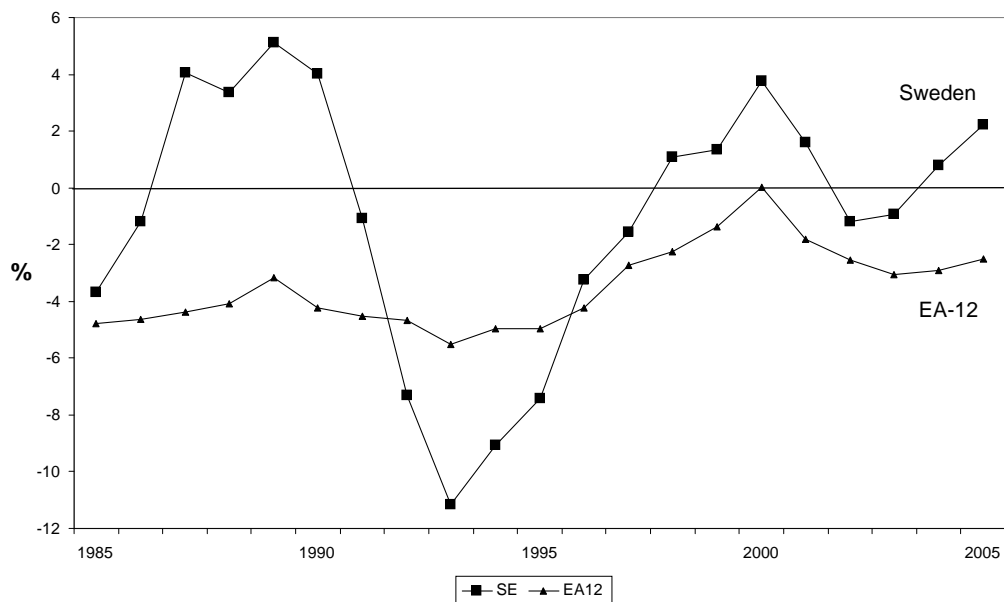
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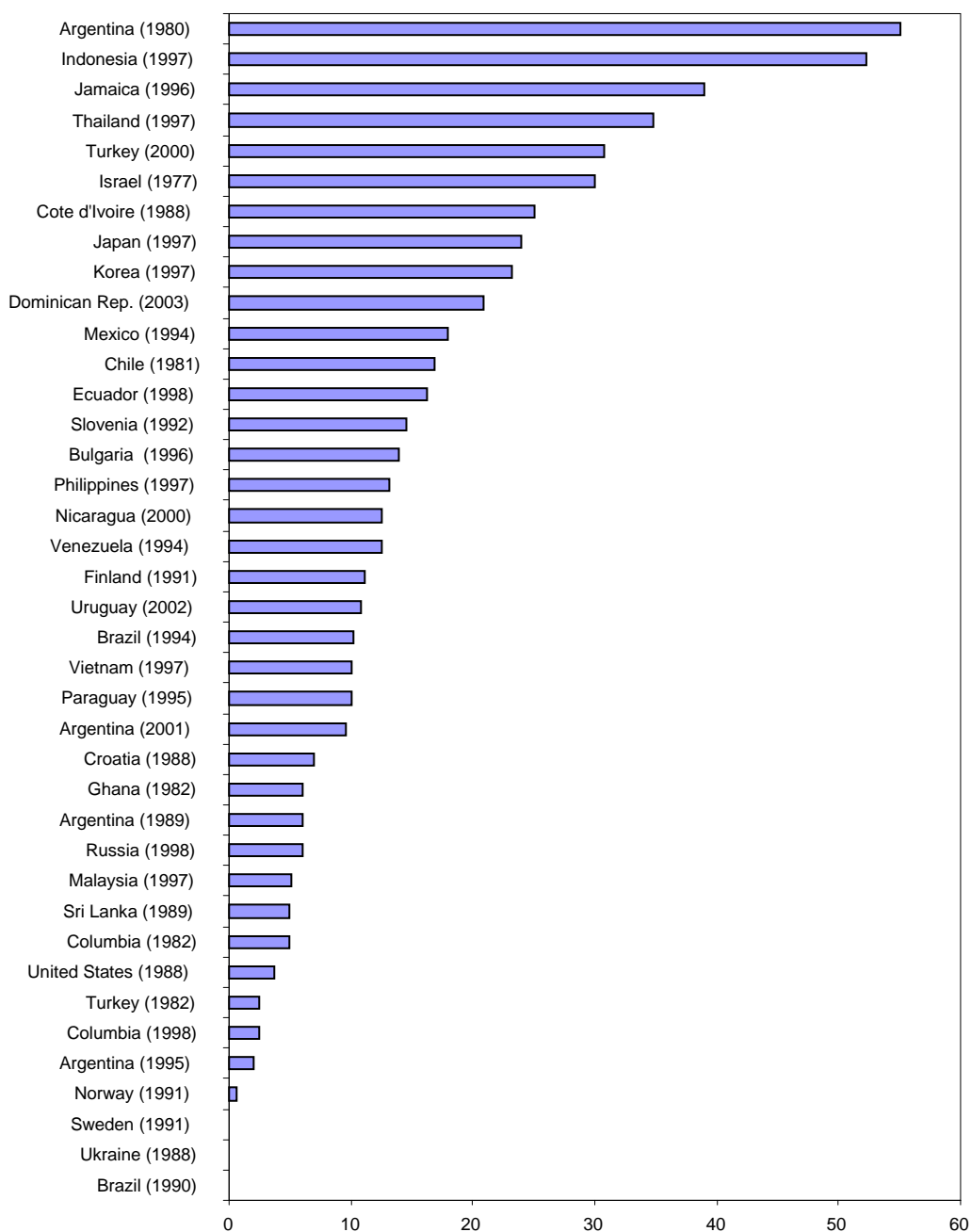
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Figure 1. The budget deficit to GDP in Sweden and the EA 12, 1985-2005. Per cent.



Source: AMECO. EA 12 encompasses the first twelve members of the euro area.

Figure 2. Net fiscal costs from systemic banking crises, 1970-2007, per cent of GDP.



Note: Net fiscal costs are government outlays during the crisis (e.g. for recapitalisation) minus recovery values during period t to $t+5$, where t is the first year of the crisis. Gross fiscal costs are used for Spain, Hungary, Israel, Poland, Romania, Slovenia and Turkey (1998).

Source: Data compiled by Andrea Schaechter from Laeven and Valencia (2008a).

Appendix 1. The press release of September 24, 1992 by the minister for fiscal and financial affairs.



SWEDISH MINISTRY OF FINANCE

September 24, 1992

Under-Secretary of State
Urban Bäckström
tel. 46-8-763 1469

Statement by the
Minister for Fiscal and
Financial Affairs, Mr Bo
Lundgren

Under-Secretary for Financial Markets
Mr Stefan Ingves
tel. 46-8-763 1522

Assistant Under-Secretary
Claes Thimrén
tel. 46-8-763 1516

Press officer
Ms Cecilia Bystedt
tel. 46-8-763 1416

MEASURES TO STRENGTHEN THE FINANCIAL SYSTEM

In the agreement a few days ago between the Government and the Social Democrats on structural measures to strengthen the Swedish economy and cut the government budget deficit it was stated that the parties consider it necessary to secure a well functioning payments system.

In a Bill to Parliament this autumn, the Government will ask for authorization to take general measures intended to strengthen the payments system and secure the supply of credit. This will also improve the conditions for a rebound of the economy.

Since the autumn of 1991 the Government has taken measures to eliminate problems affecting Första Sparbanken, Nordbanken and lately Gota Bank.

The measures put forward in the Bill will create a framework to ensure the functioning of the Swedish banks and their subsidiaries. This also applies to the functioning of those credit institutions outside the banking sector which have a Government affiliation, e.g. Stadshypotek, SBAB and Landshypotek.

The obligations of these institutions will be honoured. The implication of this is that households, enterprises and other holders of claims can feel safe.

The Government's commitment will remain as long as is necessary and will subsequently be reduced in such a way that the interests of creditors will not be jeopardized.

The general measures proposed will imply:

- that the Government is authorized to decide on guarantees, loans and supply of capital or to take other measures to increase or strengthen the capital base of the banks and of credit institutions with Government affiliation.
- that all banks, also those already affected by Government measures, and credit institutions with Government affiliation will on a voluntary basis and within a given scope be eligible for supporting measures. The banks will thus have the capacity to honour the obligations of their subsidiaries.
- that subsidies will be kept at a minimum and that any support given will be repaid as far as possible out of the profits that will arise when the situation has been stabilized. Thus, the cost for the taxpayers will be lessened.
- that the support measures will be given such forms that possible distortions of competitive conditions are minimized.
- that the Government while giving financial support can request structural changes and rationalisations. A bank or a credit institution with Government affiliation that wishes to become eligible for the measures that will be proposed should have a business that can be expected to be profitable in a longer perspective. Otherwise a restructuring, in an orderly way, of the banking system will be accepted.

- that the measures initially will be handled by a special group within the Ministry of Finance. Later on a special authority may be established.

The Government has in these matters conferred with the Social Democrats and measures will be taken unanimously.