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THE ECONOMICS OF MONEY, BANKING AND FINANCE

A European Text

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The Economics of Money, Banking and Finance

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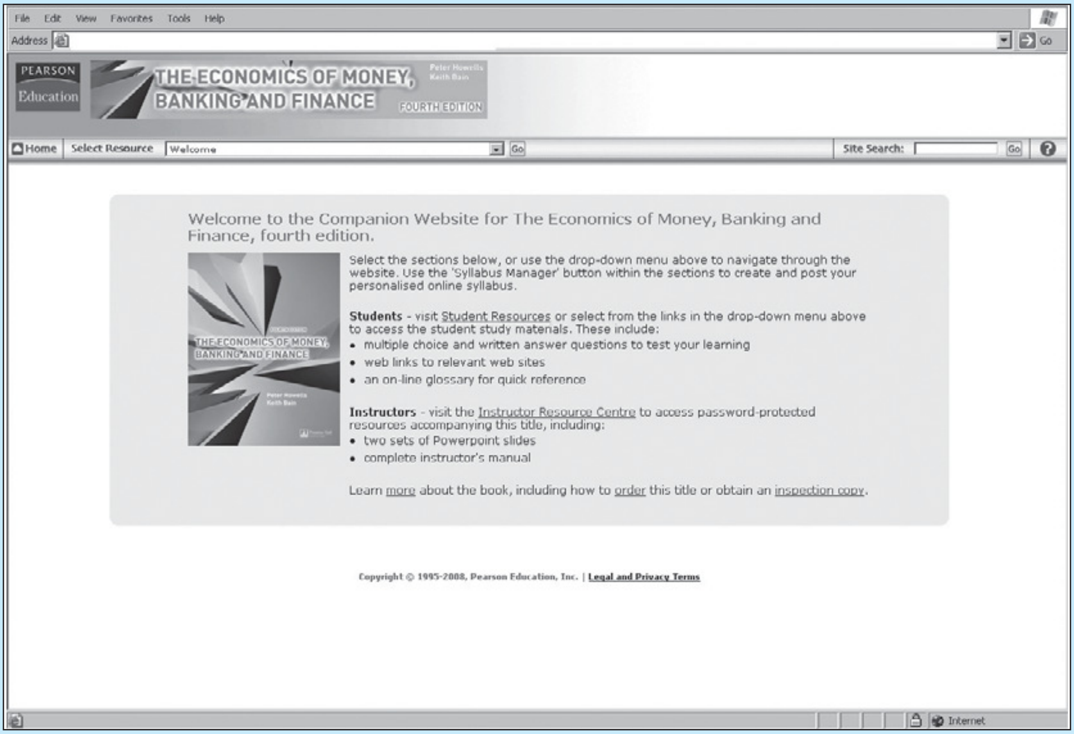

which were legally obliged to hold certain shares of government bonds in their portfolios. The equity markets were quiet places, too, as the open trading of shares was rather marginal; most of the shares were continuously held for purposes of strategic control or as long-term investments in fund portfolios.

As in many other countries, this changed with financial market deregulation and integration in the 1980s. Many Scandinavian companies had begun to circumvent the exchange controls or to use 'grey' credit markets, when prices, interest rates and exchange rates became increasingly volatile in the 1970s. As the governments and central banks noticed that quantitative regulation no longer ensured control of activities in the financial sector, they abolished controls over banks' lending volumes and interest rates at the same time as they created open money markets and bond markets as arenas for their use of interest rate policy. And they dismantled other portfolio restrictions and exchange controls, so that equity markets became increasingly attractive.

Deregulation did not come everywhere at the same time. In Denmark, the process had already started around 1975, since the country had joined the European Economic Community (EEC, now the European Union) and had to adjust to EEC rules and regulations. In Sweden and Norway, the biggest changes came with the creation of fully fledged money and bond markets in the early 1980s, whereas in Finland, functioning secondary markets for bonds and equities appeared only at the beginning of the 1990s (Oxelheim, 1996, ch. 15).

The years around 1985 nevertheless mark a period of extraordinary credit expansion in all four countries, which clearly had its root in the deregulation of the financial sectors. Unfettered competition in the loan markets led to a sharp increase in bank lending to investments in commercial and residential property as well as equity. As a consequence, a debt–asset price cycle developed that interacted with accelerating inflation. Competition kept nominal interest rates at a low level, and real interest rates were even lower due to inflation. Borrowed funds helped to fuel the rise in asset prices which, in turn, helped to increase the borrowing capacity of firms and households. And the banks pushed on in their race for market shares and profits. Between 1982 and 1989, house prices in Sweden rose by 50 per cent, commercial property prices by almost 200 per cent, and equity prices by almost 400 per cent (OECD, 1994, Annex III). Similar developments took place in Norway and Finland. In Denmark, the asset price inflation was considerably lower, since the market expansion was both stretched over a longer time and more restricted by the relatively high interest rates that *Danmarks Nationalbank* had to set in order to meet its exchange rate targets within the European Monetary System.

The debt–asset price cycles of Sweden, Norway and Finland proved to be unsustainable when real interest rates surged to unprecedented levels around 1990. A worldwide recession, the breakdown of (trade with) the Soviet Union and the weakened confidence in the (then) fixed exchange rates led the central banks of the three countries to pursue strongly disinflationary policies. The speculative bubbles in the property and equity markets burst and produced heavy credit losses, which brought many of the largest banks of Scandinavia to the verge of collapse – and with them the whole of the financial systems.

Sweden, Norway and Finland thus experienced severe banking crises that quickly proved to be too strong for ordinary 'lending of last resort' by the central banks.[6] The central governments had to intervene, but the type and costs of their rescue operations differed considerably between the three countries (see Table 7.5 overleaf). In Norway and Finland, the rescue operations were largely carried out with resources from the central banks and government funds, whereas in Sweden the central government alone has been involved. The Swedish solution of the problem was quite spectacular and much debated. Between autumn 1992 and the end of 1993, the central government provided unlimited state guarantees for all commitments of banking institutions towards creditors and depositors. Prior to this, the government had injected large funds into the three banks whose equity capital was wiped out by the credit losses. *Nordbanken*, which had been a state-majority owned bank, and *Gota Bank* were completely taken over by the state and stripped of their bigger problem assets which were transferred into two newly created, state-owned '**bad banks**',

6 In Norway, the wave of credit losses had actually started as early as 1988, but there was little recognition that a banking crisis had occurred before similar problems made themselves more strongly felt in Sweden and Finland in 1991; see Reve (1996).

Table 7.5 Assets of major banks and costs of rescue operations in the banking sector (%, as a share of GDP 1992)

	Assets of five largest banks	Assets rescued	Costs of rescue operations
Sweden	121.0	31.0	5.2
Central government			*5.2*
Finland	102.0	16.0	7.4
Central government			*1.7*
Government funds			*3.0*
Central bank			*2.7*
Norway	69.0	46.0	3.0
Central government			*2.8*
Government funds			*0.1*
Central bank			*0.1*

Source: Tables A5 and A6, OECD (1994). Reprinted with permission.

Securum and *Retriva*.[7] Even all the other big banks seized the chance to recycle their bad assets through such tax-and-cost-saving special institutions.

The immediate costs of these rescue operations were considerable, about 5 per cent of 1992 year's GDP in Sweden (see Table 7.5). Since they had to be borne by the taxpayer and since the banks' shareholders were treated rather generously, there was some debate about 'moral hazard' problems. Moreover, it was argued that the bail-out through state guarantees and bad banks tends to undermine incentives to cost-efficiency in the banking business and that it has placed the more prudent banks at a competitive disadvantage. More than fifteen years after the outbreak, the total costs of the Swedish banking crisis are still an issue of controversy. Technically, the handling of the problem assets was quite successful. When *Securum*, the biggest bad bank, was liquidated in 1997, a large share of the problem assets and institutions had been sold off at reasonable prices, so that it was estimated that nearly half of the state's immediate costs of the rescue operations had been retrieved. Yet the bad banks themselves were accused of liquidating too many companies and jobs on their way. And the reshaped 'good' banks were very restrictive in their lending in the first years after the crisis. It is nevertheless fairly safe to conclude that the total costs of the banking crisis would have been much higher for the Swedish economy, if the state had not bailed out the banks.

7.4.2 Concentration in the Nordic financial sector

We have seen in Section 7.2 that the banking sectors are highly concentrated in all Scandinavian countries. A joint report by the Nordic Central Banks (Danmarks Nationalbank *et al.*, 2006, pp. 10 and 50) shows that, by the end of 2005, the five largest banks accounted for 84.2 per cent of the total balance sheets of Swedish credit institutions; the corresponding figures were 83.1 per cent for Finland, 66.3 per cent for Denmark, and 48.7 per cent for Norway.[8] The degrees of concentration have been relatively high for a long time. They are, as such, a rather common phenomenon in small countries, reflecting the existence of economies of scale and scope in the banking business which imply that banks need to be of a certain size in order to work

[7] 'Bad banks' are special institutions whose task is to save 'good banks' by buying some of the latters' problem assets (mostly non-performing loans), presumably at low prices. The 'good banks' are then allowed to write off the losses and save taxes and further costs. The 'bad banks' reschedule the loans, restructure the borrowers' business or sell off the collateral, usually within the framework of special regulations and a predefined period. In the 1990s, the Swedish strategy of 'bad banking' achieved model character for the restructuring of crisis-stricken banking sectors in other countries; see Hawkins and Turner (1999).

[8] It should be noted that these figures relate to the total of all credit institutions, which is why they are lower than the figures provided in Sections 7.2.2 and 7.2.3 where 'mortgage banks' and 'other credit institutions' had been excluded.

efficiently. But the concentration process has been intensified in recent years; and it has taken the Nordic financial sectors several steps closer towards the domestic integration of different segments and towards their **cross-border integration**. This process is, to a large extent, a by-product of the banking crises, because they created an atmosphere in which the consolidation of the banking sector was given strong priority – especially in view of the ongoing integration process on the level of the European Union.

Close to collapse as the Swedish banks were in 1992, they quickly recovered in the following years, with some appetite for expansion in and beyond the Nordic region. In 1993, *Nordbanken* went ahead to buy *Gota Bank*, the other problem bank. What first looked like a club of losers became the core of *Nordea*, now the biggest financial services group in Scandinavia whose total assets (€375 billion in October 2007) amount to nearly as much as the combined GDPs of Denmark and Finland. *Nordbanken* merged with the Finnish Merita Bank in 1997, and their joint holding began to acquire other large banks as well as mortgage institutions and insurance companies in all the Nordic countries. The conglomerate changed its name to *Nordea* in 2001; its history (outlined under www.nordea.com) is the perfect example of cross-border and cross-segment integration of financial activities in the region.

Other banks have expanded in similar ways, though on a smaller scale. Nearly all of the large new holdings have set up subsidiaries in the Baltic countries and some, like Nordea and the Swedish SEB, have even started to acquire larger banks on the Continent. Some banks, like *Swedbank*, have chosen to forge strategic alliances with banks in other countries that have a similar background in savings and union banking.

This wave of mergers, acquisitions and alliances is not a specific characteristic of the Nordic financial sector. As financial institutions prepared for intensified competition in the European financial markets, these things have happened everywhere. Yet it is remarkable that the concentration has almost exclusively been an intra-Nordic affair. Financial institutions from countries outside Scandinavia have so far had little success in penetrating the markets in the Nordic countries (Engwall *et al.*, 2001; Danmarks Nationalbank *et al.*, 2006, p. 42).

Two other characteristic features of the ongoing concentration process are the strategies of all-finance and electronic banking. The term 'all-finance' describes cross-segment integration, that is: a tendency of financial groups, like *Nordea*, to offer the full range of banking and financial services under one brand, including insurance and pension fund management. In addition, Scandinavian banks do currently have a lead in the technologies of electronic banking. What is normally regarded as a disadvantage of the Nordic countries, namely their low population density, has turned out to be an advantage in the diffusion of new techniques. The costs of setting up brick-and-mortar branches of financial institutions are particularly high in sparsely populated countries. This gives the financial services groups extra incentives to exploit the economies of scope from all-finance and the economies of scale from electronic banking. Technical progress and the concentration process interact, since profits from electronic banking tend to grow with network size, and mergers and acquisitions enlarge the networks.

The emergence of transnational financial groups increases the need for cooperation between the supervisory authorities of the countries involved. The supervisory authorities of the Nordic countries have therefore extended their practical cooperation in the control of banks, insurance and investment companies. The central banks regularly publish reports on financial stability in which they increasingly set their focus on the cross-border activities of the financial institutions in their domains.

7.5 Monetary policy strategies in the Nordic countries

It has been pointed out in Sections 7.1 and 7.2 that the Scandinavian central banks pursue different targets in varying frameworks of monetary policy. Sweden has an independent central bank that follows an **inflation target** (2 per cent, ± 1 per cent) under flexible exchange rates. Denmark too has an independent central bank, but it has pegged its currency to the euro at an exchange rate of 7.46 DKr/€ in the narrow target zone of ERM II (± 2.25 per cent). Norway has a less independent central bank which, however, can exert more discretion in preserving monetary stability as it has gone over from a **'soft' exchange rate target** to inflation targeting. Finland no longer has a monetary policy of its own, as it is a member of the European Monetary Union; the Bank of Finland supports the European Central Bank in its pursuit of an inflation target, but that target (2 per cent or less) is defined as an average of the whole eurozone, not of Finland alone.

In this last section, we shall discuss the following questions: Why this diversity? And can the national monetary policy strategies diverge when the main players in the private sector converge to large transnational financial groups? The first question is about the recent past, the second is about the near future.

7.5.1 The origins of the diversity

Until autumn 1992 all four Scandinavian countries adhered to similar types of fixed exchange rate arrangements. As an EEC member, Denmark joined the Exchange Rate Mechanism of the European Monetary System (EMS) in 1979, whereas the other three countries pegged their currencies to trade-weighted currency baskets. Yet exchange rate stability was difficult to achieve, as the oil crisis of 1973/74 had set off price–wage spirals that led to relatively high inflation in the Scandinavian countries, reinforced by the effects of income tax progression. Due to the fast increase in unit costs, the Scandinavian industries began to lose ground in their export markets. Devaluations were often used as a way out of this problem, but they tended to come late, to weaken the confidence of investors and to add to the inflation problem by raising import prices. During the 1970s and early 1980s, all four countries were thus caught in vicious circles of inflation and devaluation which eroded both the competitive advantages of the region's export industries and the systems of **credit and exchange controls**.

Due to its constraints in the EMS, Denmark was the first country to break these circles by going over to a rigorous austerity policy, but the change to low inflation and durable exchange rate stability came at the hefty cost of high and persistent unemployment. This was a price that the other countries, in particular Sweden, were not prepared to pay. Instead, Sweden tried to fight its way out of the dilemma by way of a shock devaluation, combined with fiscal consolidation, wage restraints and financial market deregulation. The 16 per cent devaluation of the Swedish crown in October 1982 was meant to stimulate exports and thereby growth and employment, but the Swedish government made it clear that this had to be the last action of its kind, if the inflation trend was to be broken. The crown was firmly pegged to a new target exchange rate vis-à-vis the currrency basket. The **deregulation and liberalization** of the financial sector was meant to subject the wage and price setters in the country to the discipline of interest rate and loan constraints. Norway and Finland followed suit – though somewhat grudgingly, because the Swedish shock devaluation had put their own export industries at a disadvantage.

The hopes of reining in inflation by way of financial market deregulation were unfounded, as we saw in Section 7.4. The inflationary impulses of wage and tax policies were replaced by the **debt–asset price cycles** in the real property and equity markets. Increasing deficits in the current accounts had to be financed with capital inflows that further contributed to inflation. When the first signs of a recession weakened the confidence of investors and threatened exchange rate stability in 1990/91, Norway, Sweden and Finland pegged their currencies to the ECU (European Currency Unit) in order to win credibility for their disinflationary policies. Like other central countries in Europe, they hoped to be able to achieve price-level stability by way of preserving strict exchange rate stability.

However, these measures backfired on the economies and eventually on the monetary policy strategies. Keeping the exchange rates fixed in terms of the ECU, or rather the Deutschmark as the anchor currency of the EMS, required a policy of high interest rates, since the German *Bundesbank* began to raise its key rate in order to fight the inflationary impulses in the wake of German reunification. The restrictive monetary policies in Sweden, Norway and Finland aggravated the problems with credit losses that had begun to develop in the banking systems.

In the summer of 1992 all hell was let loose, when a referendum in Denmark resulted in a 'No' to the Maastricht treaty and its plans for a European Monetary Union. As the trend towards irreversibly fixed exchange rates in Europe seemed no longer certain, it became attractive to speculate against the currencies of European countries that suffered either from high inflation or from high unemployment. The Danish crown was relatively well protected, since its peg to the ECU was multilaterally defended, mainly by support from the German *Bundesbank*. The northern Scandinavian currencies were unilaterally pegged to the ECU and they were traded in small foreign exchange markets with few big players. This made them much easier targets for speculative attacks.

The Swedish government and the *Riksbank* were determined to defend the symbol of their newly won credibility, the fixed ECU exchange rate, at all costs. In September 1992, the *Riksbank* raised its lending rates to the banks to 500 per cent in order to stop the vicious circle of self-fulfilling expectations which threatened to develop from the massive increase of loans at Swedish banks that were converted into foreign currencies in speculative anticipation of a devaluation of the crown. These draconian measures, rather uncommon in highly developed economies in times of peace, only brought the banking system closer to collapse and invited further speculative attacks. After very costly, but eventually futile interventions in the foreign exchange markets the *Riksbank* abandoned the unilateral ECU parity in November 1992. Finland had gone over to floating exchange rates in September, and Norway followed in November.

To sum up, there is some irony in the fact that the northern Scandinavian countries tried to use the deregulation of the financial sectors as a vehicle for regaining interest rate control and winning credibility for their policies of disinflationary exchange rate targetting. The inflationary dynamics of the deregulation process contributed to the deep economic and banking crises which, in turn, made the exchange rate arrangements unsustainable.

Yet the four Nordic countries have all reacted differently to the **currency crises** of the early 1990s. Denmark survived the speculative attacks and stuck to its ECU peg (now a euro peg), but it did not join the European Monetary Union (EMU) because there is strong political opposition to the project of a single European monetary policy in the country. Once bitten, twice shy, public opinion in Sweden is also dominated by eurosceptical positions, and it is widely argued that it is easier to fight inflation by directly targeting it in the country than leaving monetary policy decisions to some central bank in Frankfurt. In the referendum of September 2003, a clear majority of Swedish voters rejected the government's plans to join the EMU. By contrast, Finland took the bull by the horns and joined the EMS in 1997 in order to become an EMU member right from the start. Norway has preferred to stay outside the European Union altogether, but it adopted a 'soft policy' of stable exchange rates shortly after the turmoil of 1992. The underlying motivation was to keep the Norwegian economy, and in particular its sectors outside the oil and gas industry, under competitive pressure. The difference compared with the earlier unilateral ECU parity was that the authorities did not define a new parity with fluctuation margins, but declared their intent to react to shocks in the foreign exchange markets by gearing monetary policy to returning the euro exchange rate gradually to its initial range. However, even this soft exchange rate targeting had to be given up in favour of inflation targeting, when the end of the 'dotcom bubble' made the Norwegian krone vulnerable to speculative attacks.

7.5.2 The problems of diversity

So far, all the different choices of monetary policy regimes in Scandinavia can be considered as being successful in terms of both preserving price-level stability and regaining financial sector stability. Yet it is not certain that the diversity of strategies can be sustained in the long run. General macroeconomic developments were unusually favourable in the second half of the 1990s, and the downswing at the turn of the century was softened by globally low interest rates. Even by 2007, the new strategies have not yet been put to the test of sudden increases in real interest rates.

Apart from macroeconomic concerns, problems may also arise from the ongoing concentration in the financial sectors of the Nordic region. In the past decades, the Scandinavian central banks have supported the creation of domestic money and bond markets in order to make use of the banks' competition for liquidity. Now they face fewer and bigger players in those markets. Moreover, the transnational financial groups have more opportunities for cross-border arbitrage and for the circumvention of specific restrictions in the countries. This may contribute to rendering monetary policy less effective or, in the case of Sweden and Norway, less independent in their pursuit of national inflation targets. Take, for example, the risks for financial stability that arise from the high share of shareholding in Sweden. If there is a sudden fall in share prices, as in the years 2000–01, the negative wealth effect on investment and consumer spending tends to be stronger than in other countries. This could induce the *Riksbank* to lower its interest rates in order to meet its inflation target.[9] If the rates come to be lower than elsewhere in Europe, banks could use the Swedish money market for borrowing funds to invest them in other countries, while investors would stay away from the Swedish markets because they can earn more elsewhere. The market levels of interest

[9] It should be noted that Sweden had exceptionally low inflation rates in the 1990s, often at or even below the lower boundary of the target zone (1–3 per cent). Due to measurement problems in the inflation rate, this would be considered as deflation which, in turn, tends to have a negative effect on real economic activity.

rates in Sweden would adjust to or even rise above the levels in the eurozone, due to a risk premium.[10]

It may therefore be concluded that the diversity of monetary policy targets and frameworks in Northern Europe will be a transitory episode, born out of crisis of its financial systems and doomed to give way to further integration of the financial sectors even at the monetary policy level – perhaps within the European Monetary Union or some satellite arrangement such as the EMS II. However, the present arrangements have proved more durable than initially expected by most observers.

7.6 Summary

The financial systems in Northern Europe are dominated by a few large domestic banks that have recently evolved into even larger Nordic financial groupings by way of cross-border mergers and acquisitions. Until the 1980s, the domestic banks were protected from the competition of foreign banks, but at the same time subject to extensive credit and exchange controls. The financial sectors were segmented by separate systems of regulation for different financial intermediaries. As quantitative regulations of credit and capital flows became increasingly ineffective in the 1980s, the monetary authorities in Scandinavia created money markets and other arenas for interest rate policies, by which they attempted to meet their exchange rate targets. The financial markets were deregulated and opened for capital flows across the borders.

The opening of the markets created a credit boom, a rise in inflation rates, and speculative bubbles in property and equity markets that were supported by huge capital inflows. Due to a combination of internal overheating and external shocks, real interest rates in Scandinavia rose to unprecendented levels around 1990. The speculative bubbles burst and produced a wave of bankruptcies, which led to a deep recession and severe **banking crises** in Sweden, Norway and Finland (and milder problems in Denmark) in the early 1990s.

As a consequence, the monetary authorities in Scandinavia began to diverge in their approaches to central bank independence and the setting of targets for monetary policy. While Denmark continued to peg her exchange rate to the ECU (now to the euro), Sweden has left her exchange rate floating and follows an inflation target since 1992. The central banks in both countries have gained operational independence vis-à-vis the respective governments. Norway has kept its central bank under the close control of parliament while going over to a softer exchange rate target and, more recently, to an inflation target. Finland has joined the European Monetary Union, thereby giving up her (formal) independence in all matters of monetary policy.

Thus there is some irony in the fact that the northern Scandinavian countries tried to use the deregulation of the financial sectors as a vehicle for regaining control over bank lending and winning credibility for their policies of disinflationary exchange rate targeting. The inflationary dynamics of the deregulation process contributed to the deep economic and banking crises which, in turn, made the original policies of fixed exchange rates unsustainable and created a diversity of monetary policy frameworks. Yet, as the main players in the Nordic financial systems have begun to converge to large transnational financial groups, the question arises, whether the national monetary policy strategies in the Nordic countries can diverge in the longer run – or whether they, too, will converge in the European Monetary Union (or some satellite arrangement).

Key concepts in this chapter

All-finance *alias* bancassurance
Bad banks
Banking crises
Concentration in the banking sector
Credit and exchange controls
Cross-border integration
Currency crises
Debt–asset price cycle
Deregulation and liberalization
Inflation target
Strategic shareholding of banks
Strict and soft exchange rate targets
'Top-down approach' to the evolution of commercial banking

[10] However, in the downswing between 2000 and 2003 there was no big difference between the wealth effects in Sweden and in the core economies of the euro area. The *Riksbank* has kept short-term interest rates relatively high and the difference between long-term interest rates in Sweden and in the euro area rarely exceeded half a percentage point.