

**THE GREAT FINANCIAL CRISIS IN FINLAND AND SWEDEN
IN THE 1990s.**

THE DYNAMICS OF BOOM, BUST AND RECOVERY

*Jan 08, 2011 8:00 am, Sheraton, Director's Row H
American Economic Association*

*Session: Nordic Financial Crises: Lessons from Finland, Iceland, Norway and
Sweden*

Lars Jonung, Jaakko Kiander and Pentti Vartia

THE GREAT FINANCIAL CRISIS IN FINLAND AND SWEDEN

THE PRE-CRISIS VIEW ON CRISIS IN FINLAND AND SWEDEN:

IT CANNOT HAPPEN HERE!

WE ARE RICH, ENLIGHTENED WELFARE STATES WITH FULL (OVERFULL) EMPLOYMENT AS OUR MAIN POLICY GOAL. WE ARE NOT LIKE CONTINENTAL EUROPE.

THE VOTERS AND THE TRADE UNIONS WOULD NEVER ALLOW A CRISIS TO OCCUR.

WE HAVE A LARGE SET OF ACTIVE AND POWERFUL POLICY INSTRUMENTS.

AND WE HAVE FIRST-CLASS ECONOMISTS READY TO SERVE AS POLICY-ADVISERS.

•

Figure 1. GDP in Finland and Sweden 1986-2000.
Yearly percentage change.

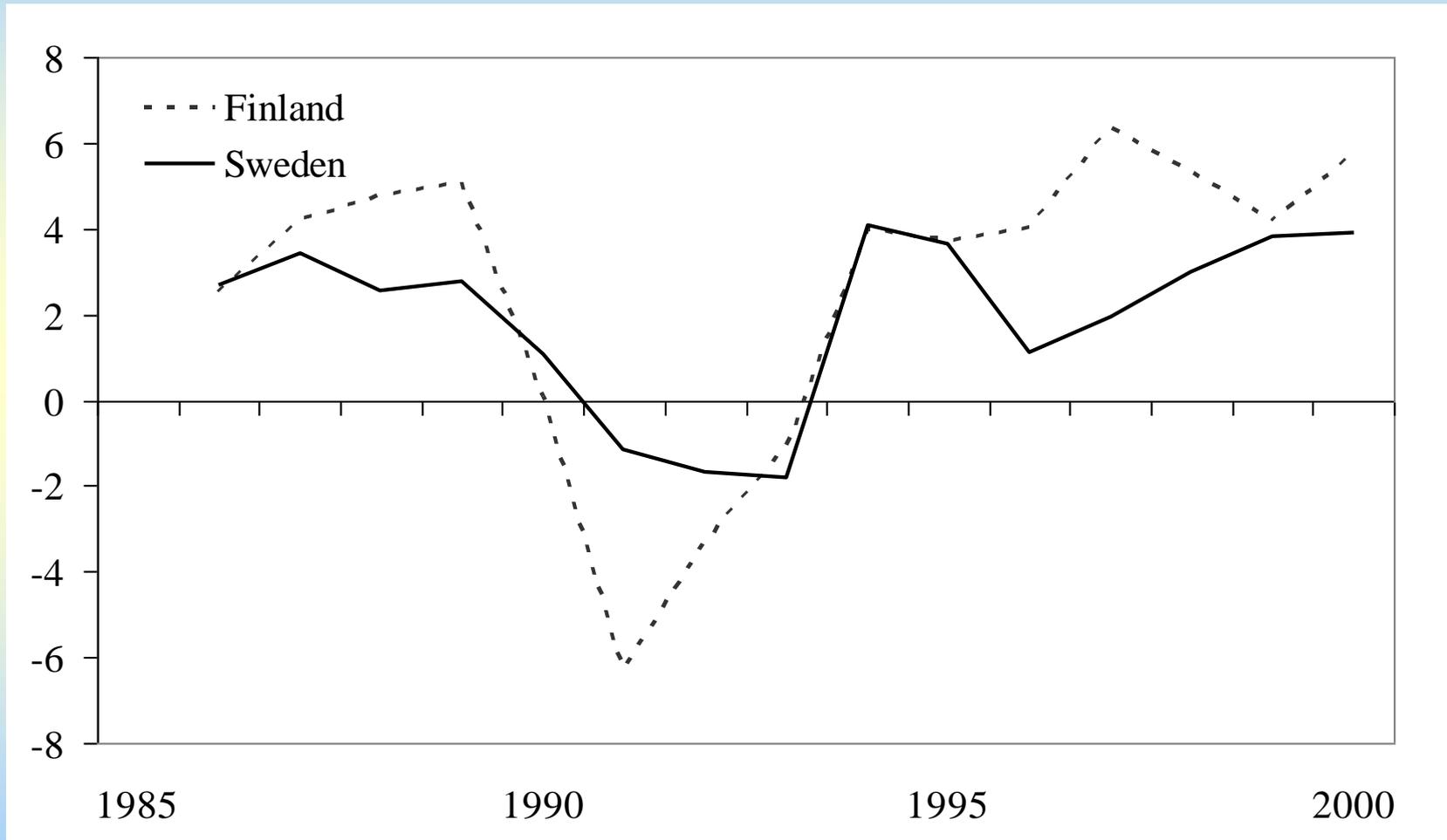


Figure 2. Unemployment in Finland and Sweden
1985-2000. Percent.

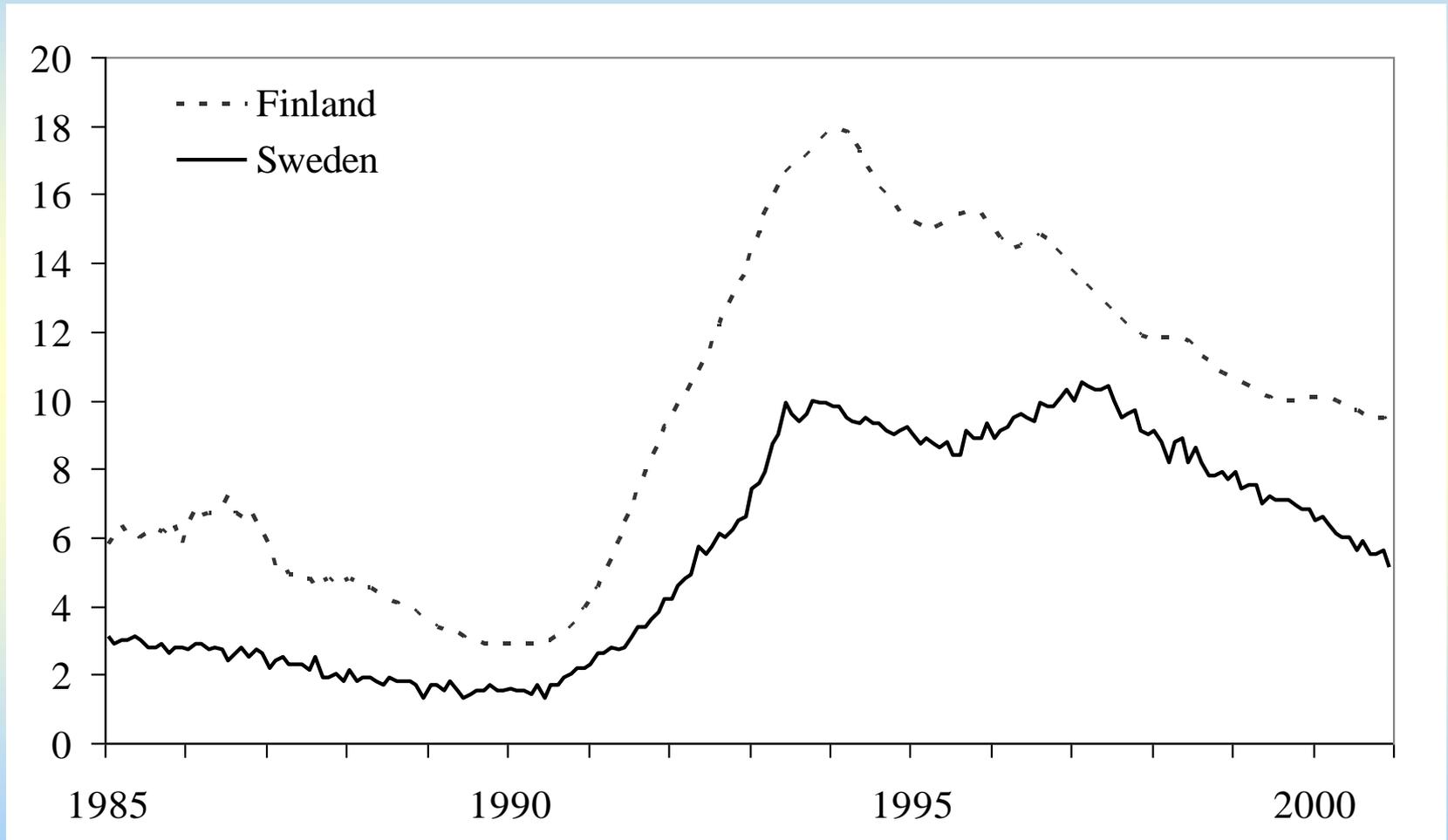


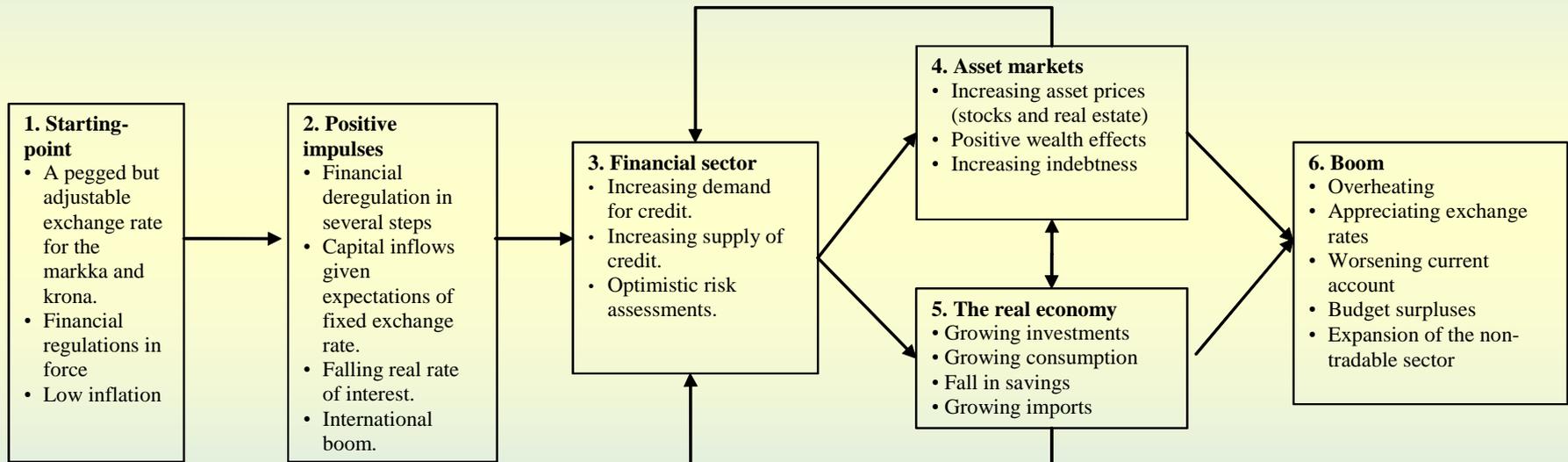
Table 1. Output losses during the deepest crises in Finland and Sweden.

Output losses during crises		
Crisis years	Finland	Sweden
1877-78	24.2	11.3
1907-08	No crisis	11.2
Crisis of the 1920s (1921)	No crisis	9.6
Crisis of the 1930s	24.3	17.7
OPEC I (1976-78)	18.7	9.9
OPEC II (1980-82)	No crisis	1.9
Crisis of the 1990s	26.4	13.0
W W I	57.8*	21.2
W W II	32.4	25.6

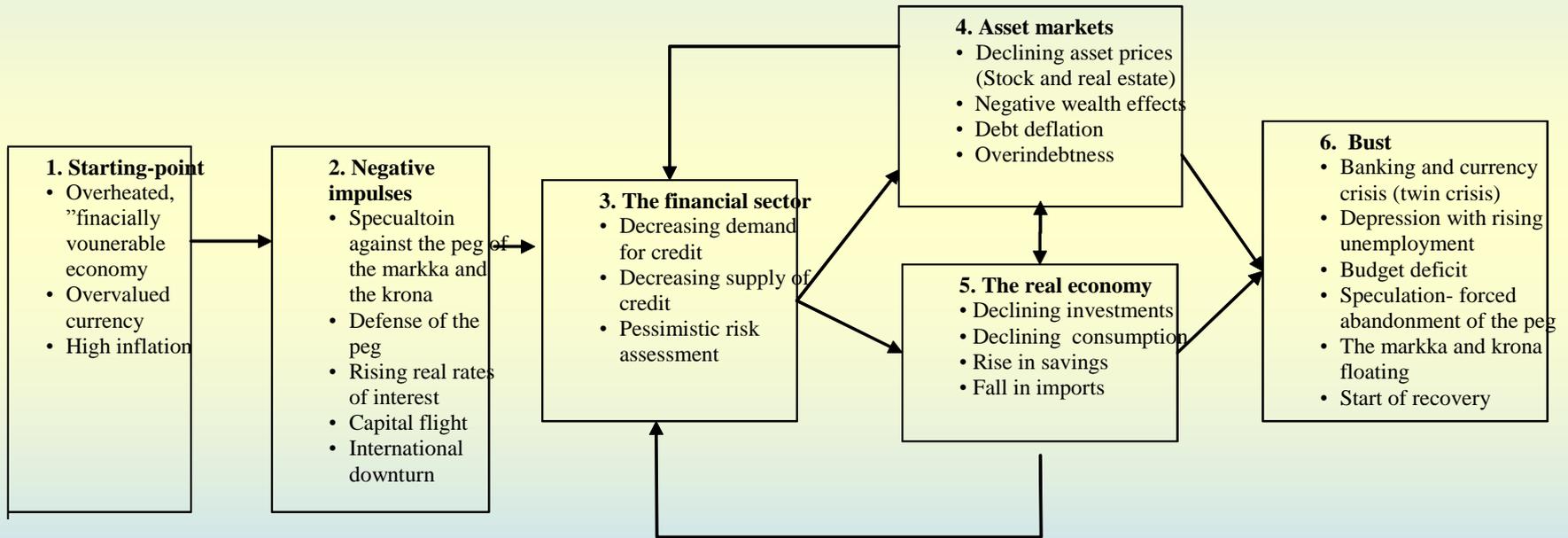
*Including the civil war.

Source: Hagberg and Jonung (2003).

The boom phase in Finland and Sweden 1985-90. A stylized picture.



The bust phase in Finland and Sweden 1990-93. A stylized picture.



Real rate of interest ex post in Finland and Sweden 1988-93. Percent.

Comment: The real rate of interest ex post after tax is calculated by the following:
 $(1 - \text{tax rate on capital}) * \text{nominal interest rate} - \text{inflation rate}$.

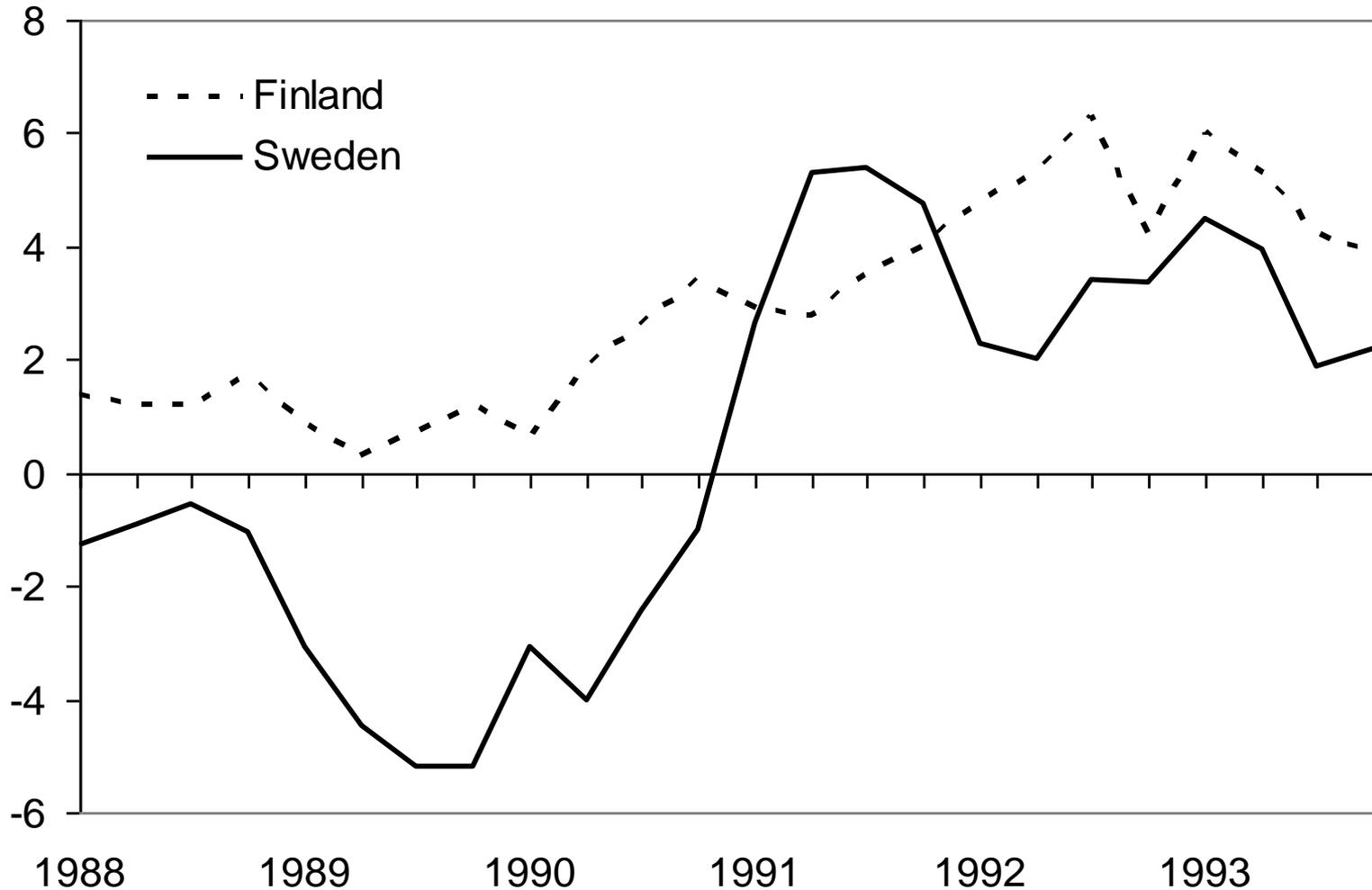
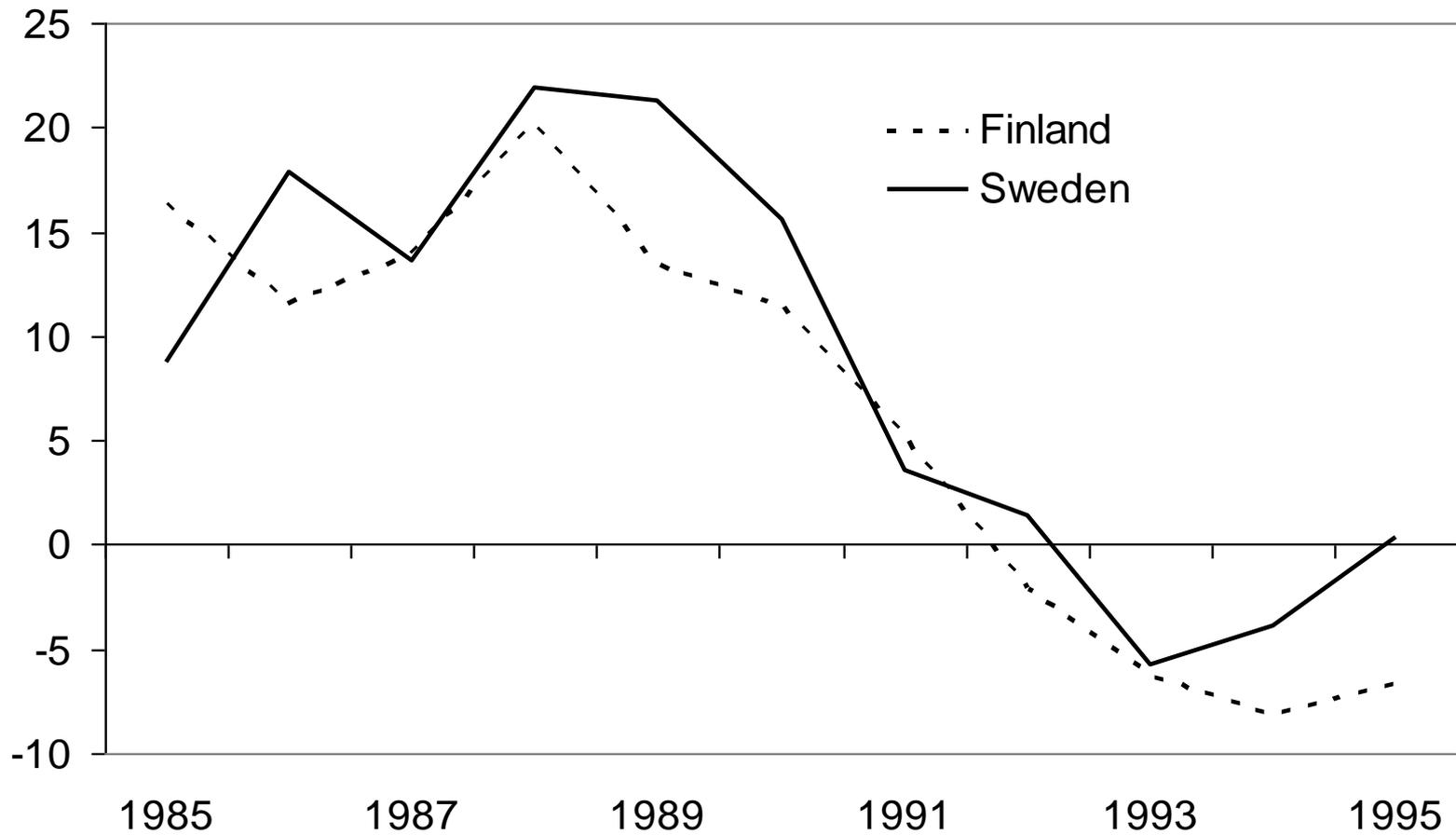
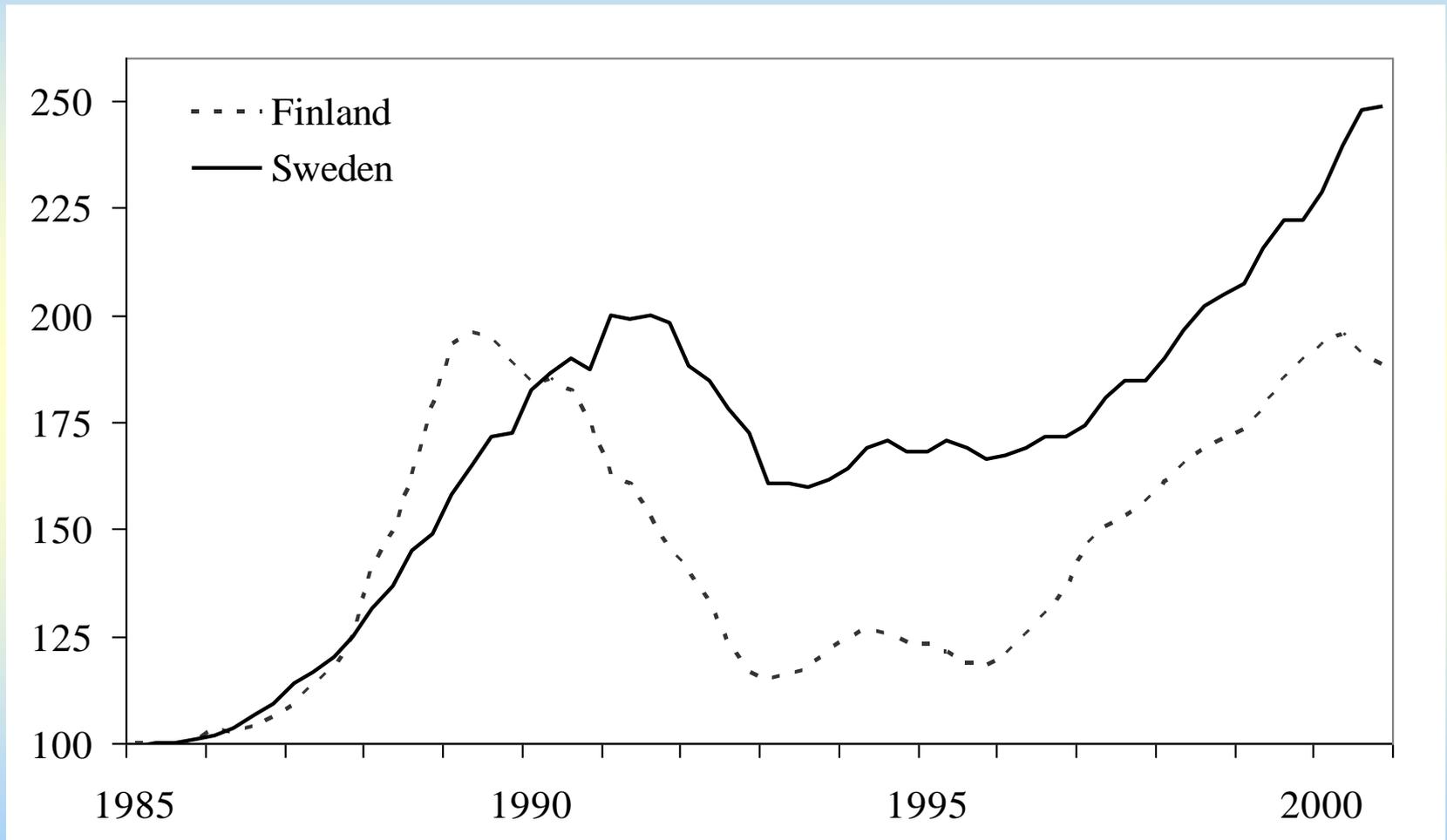


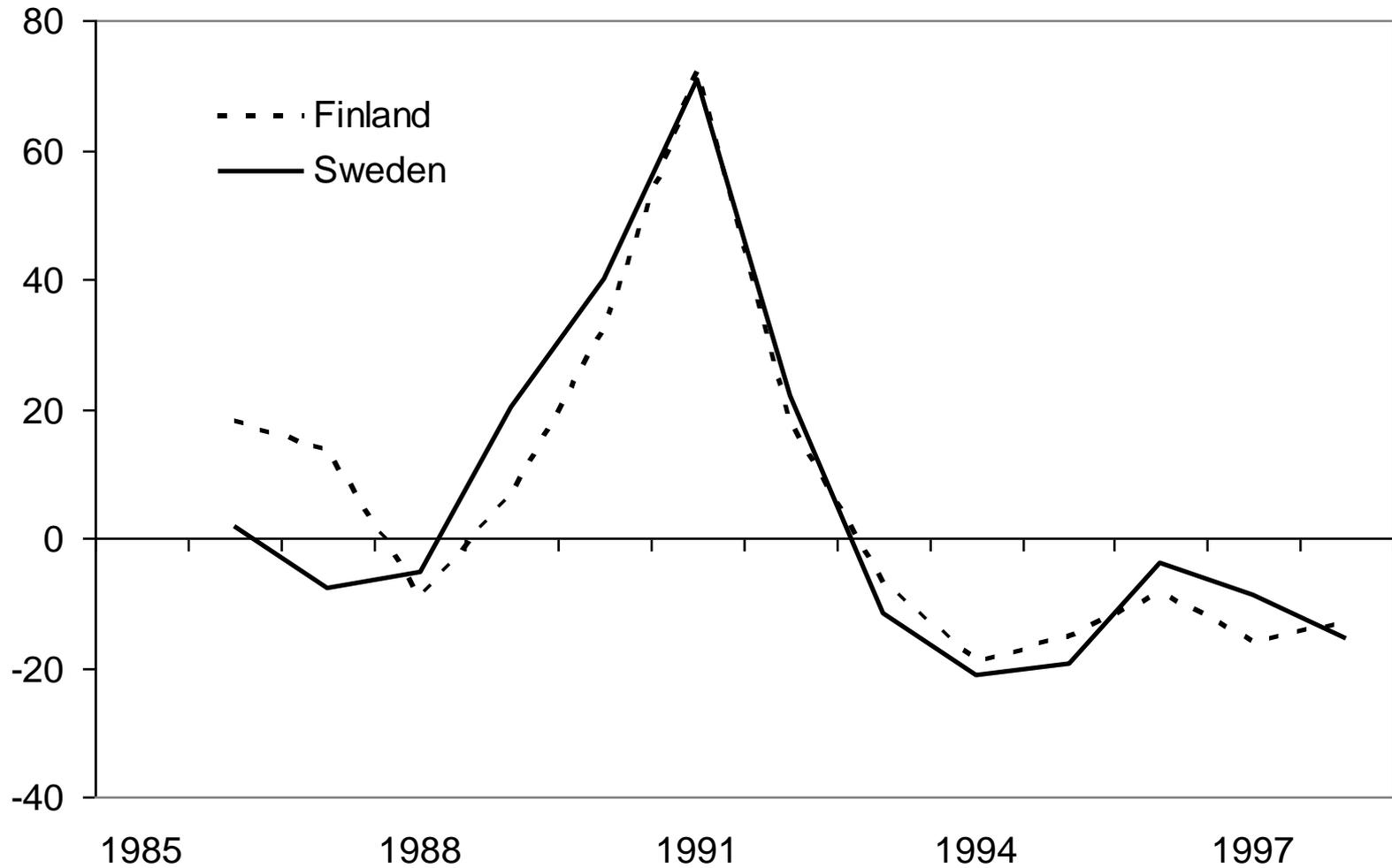
Figure 9. Volume of credit in Finland and Sweden
1985-1995. Yearly percentage change.



Housing prices in Finland and Sweden 1985-2000. 1985=100.



Number of bankruptcies in Finland and Sweden 1986-98. Yearly percentage change.



THE GREAT CRISIS IN FINLAND AND SWEDEN

THE RECOVERY 1993-2000

BOTH COUNTRIES EXPERIENCED A PROLONGED PERIOD OF RAPID GROWTH AFTER THE FLOATING OF THEIR CURRENCIES IN 1990.

FINLAND AND SWEDEN EXPERIENCED THE SAME QUICK RECOVERY DURING THE YEARS 1993-2000. THE LONG RECOVERY WAS FACILITATED BY THE FALL IN INTEREST RATES. THIS COUNTERED THE DEBT DEFLATION TENDENCIES IN THE DOMESTIC ECONOMY. INTERNATIONAL ECONOMIC DEVELOPMENTS ALSO FACILITATED THE RECOVERY.

MONETARY POLICIES IN FINLAND AND SWEDEN TURNED EXPANSIONARY AFTER THE DECISION TO FLOAT IN THE FALL OF 1992. THE SWEDISH RIKSBANK DECLARED AN INFLATION TARGET OF TWO PERCENT PER ANNUM IN JANUARY 1993. THE BANK OF FINLAND TOOK A SIMILAR STEP THE SAME YEAR.

THE GREAT CRISIS IN FINLAND AND SWEDEN

THE MAIN FORCE BEHIND THE RECOVERY WAS THE DEPRECIATION OF THE *MARKKA* AND THE *KRONA* THAT FOLLOWED THE DECISION TO LET THE TWO CURRENCIES FLOAT DURING THE FALL OF 1992. THE COMPETITIVE ADVANTAGE CREATED BY THE DEPRECIATION WAS SURPRISINGLY LONG LASTING. EXPORTS FROM BOTH COUNTRIES GREW STRONGLY AND THE SURPLUS ON THE CURRENT ACCOUNT INCREASED, MAKING IT POSSIBLE TO REDUCE THE VOLUME OF FOREIGN DEBT, HELD BOTH BY THE PUBLIC AND PRIVATE SECTOR. THE RAPID RISE IN EXPORTS PAVED THE WAY OUT OF THE CRISIS.

HIGH UNEMPLOYMENT EXPLAINS WHY THE RECOVERY COULD TAKE PLACE WITHOUT LARGE NOMINAL WAGE INCREASES. UNEMPLOYMENT FELL SLOWLY DURING THE LATTER HALF OF THE 1990S. HOWEVER, EMPLOYMENT NEVER RETURNED TO THE HIGH LEVELS THAT WERE RECORDED SHORTLY PRIOR TO THE CRISIS.

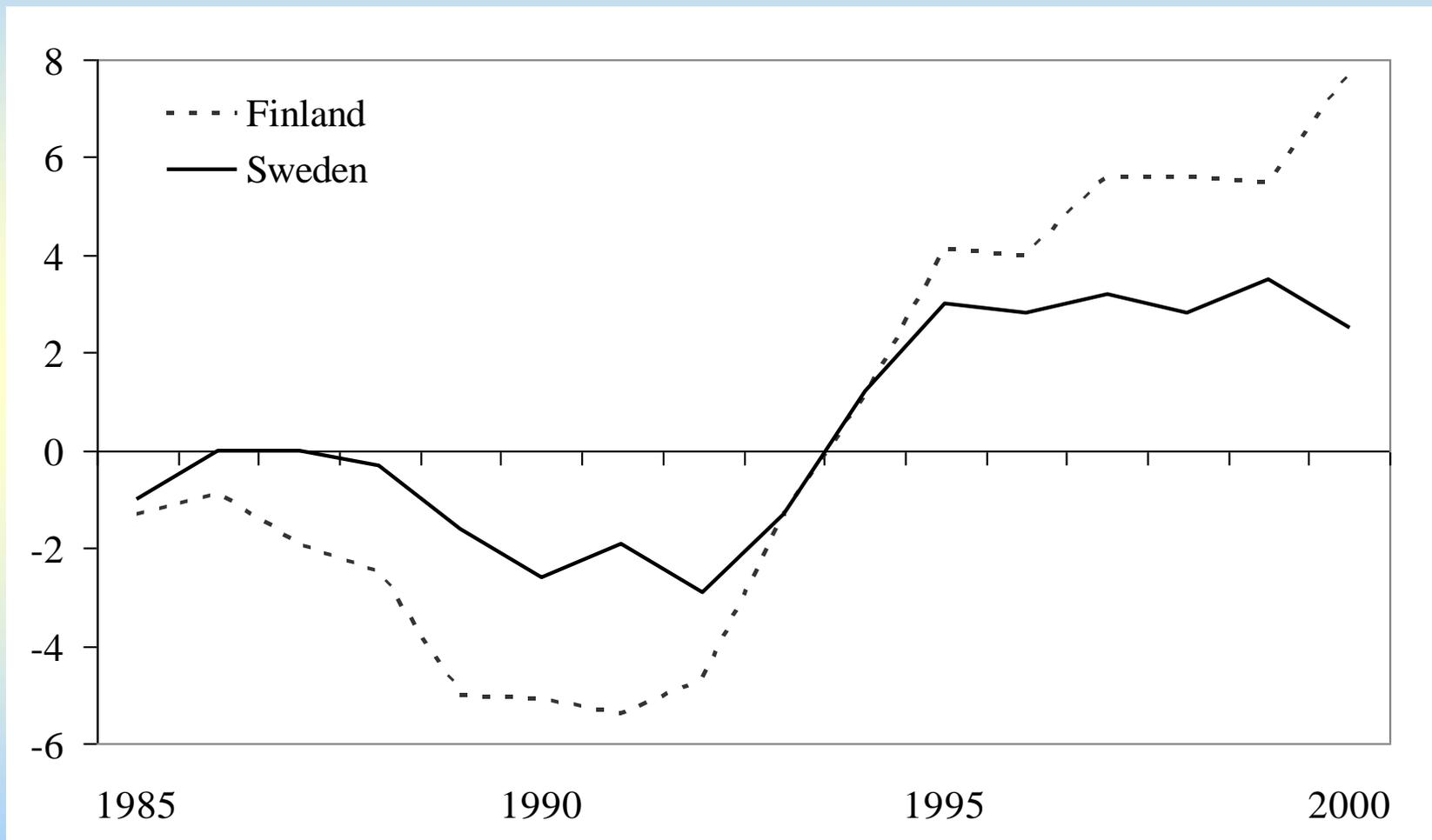
THE GREAT CRISIS IN FINLAND AND SWEDEN

THE CRISIS CAUSED A MAJOR RESTRUCTURING OF FINNISH AND SWEDISH INDUSTRIES, MAKING THEM MORE DYNAMIC AND COMPETITIVE INTERNATIONALLY. THE RISE IN ICT-RELATED INDUSTRIES, NOTABLY NOKIA IN FINLAND AND ERICSSON IN SWEDEN, WAS A REMARKABLE PART OF THE RECOVERY. PRODUCTIVITY IMPROVED SIGNIFICANTLY DURING THE RECOVERY. PRODUCTIVITY GROWTH BECAME HIGH AND LASTING IN BOTH COUNTRIES.

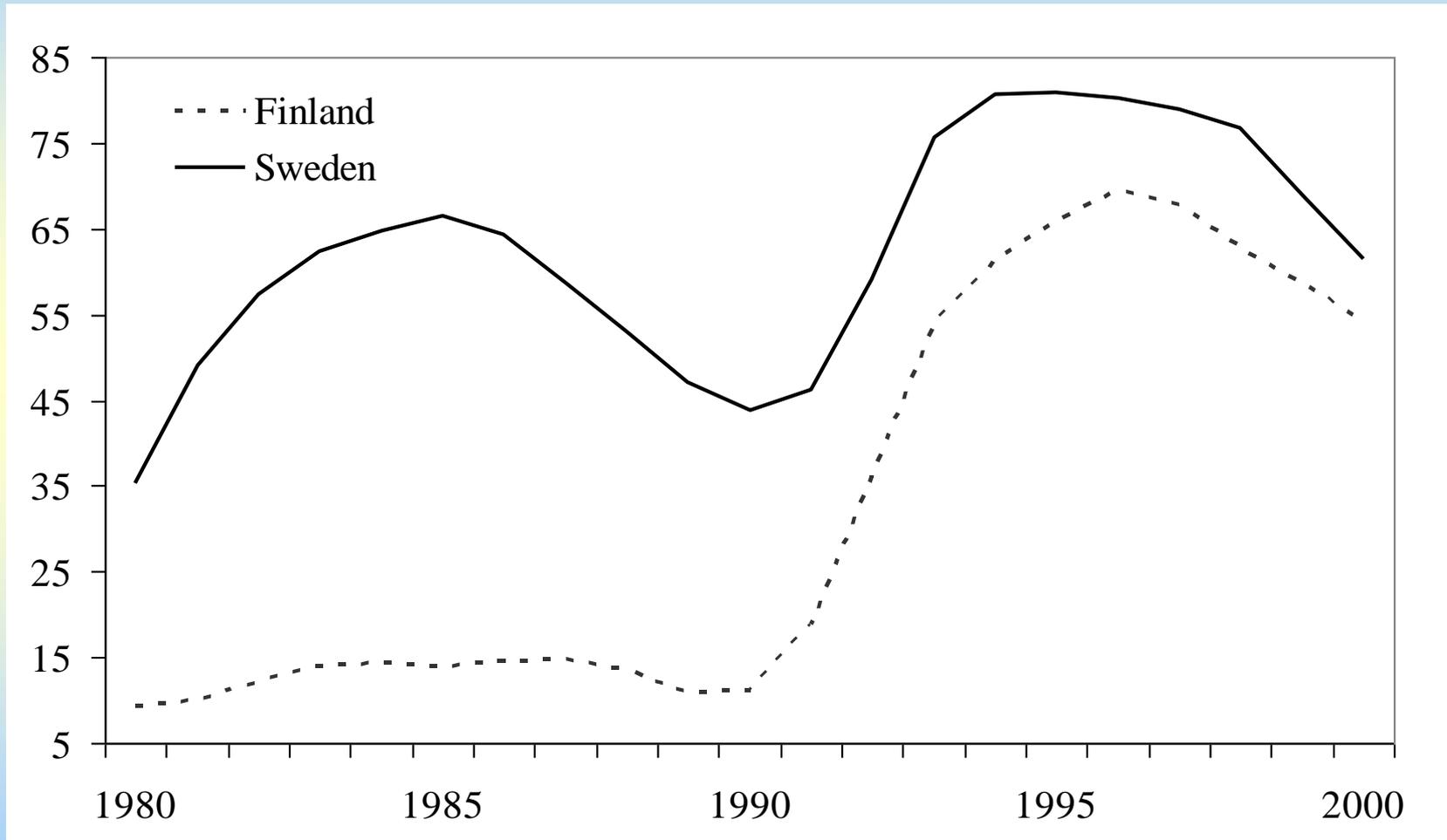
FISCAL POLICY WAS RESTRICTIVE DURING THE RECOVERY. AS THE ECONOMIES STARTED TO GROW DURING THE RECOVERY, BUDGET DEFICITS WERE REDUCED. DURING THE RECOVERY, FISCAL POLICIES WERE DIRECTED TO BRINGING ABOUT BUDGET SURPLUSES AND REDUCING GOVERNMENT DEBT. THERE WAS NO ROOM FOR DISCRETIONARY FISCAL POLICIES.

THE WELFARE STATE – THAT IS THE LARGE PUBLIC SECTOR – IN BOTH FINLAND AND SWEDEN REMAINED BASICALLY UNCHANGED DURING THE 1990S. THE RECOVERY DOES NOT APPEAR TO BE THE RESULT OF SCALING BACK OF PUBLIC SERVICES.

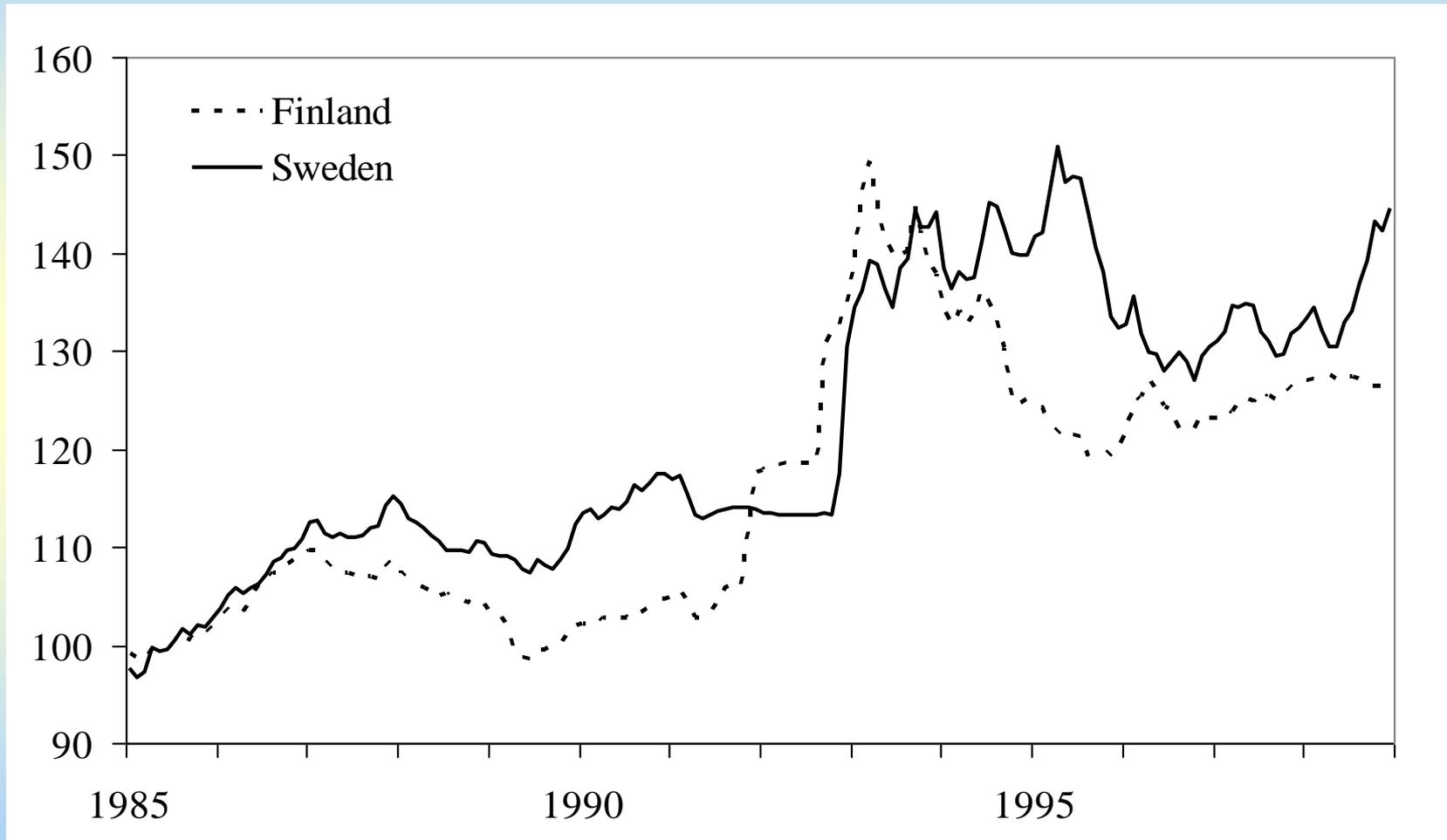
Current account balance as percentage of GDP in Finland and Sweden 1985-2000. Percent



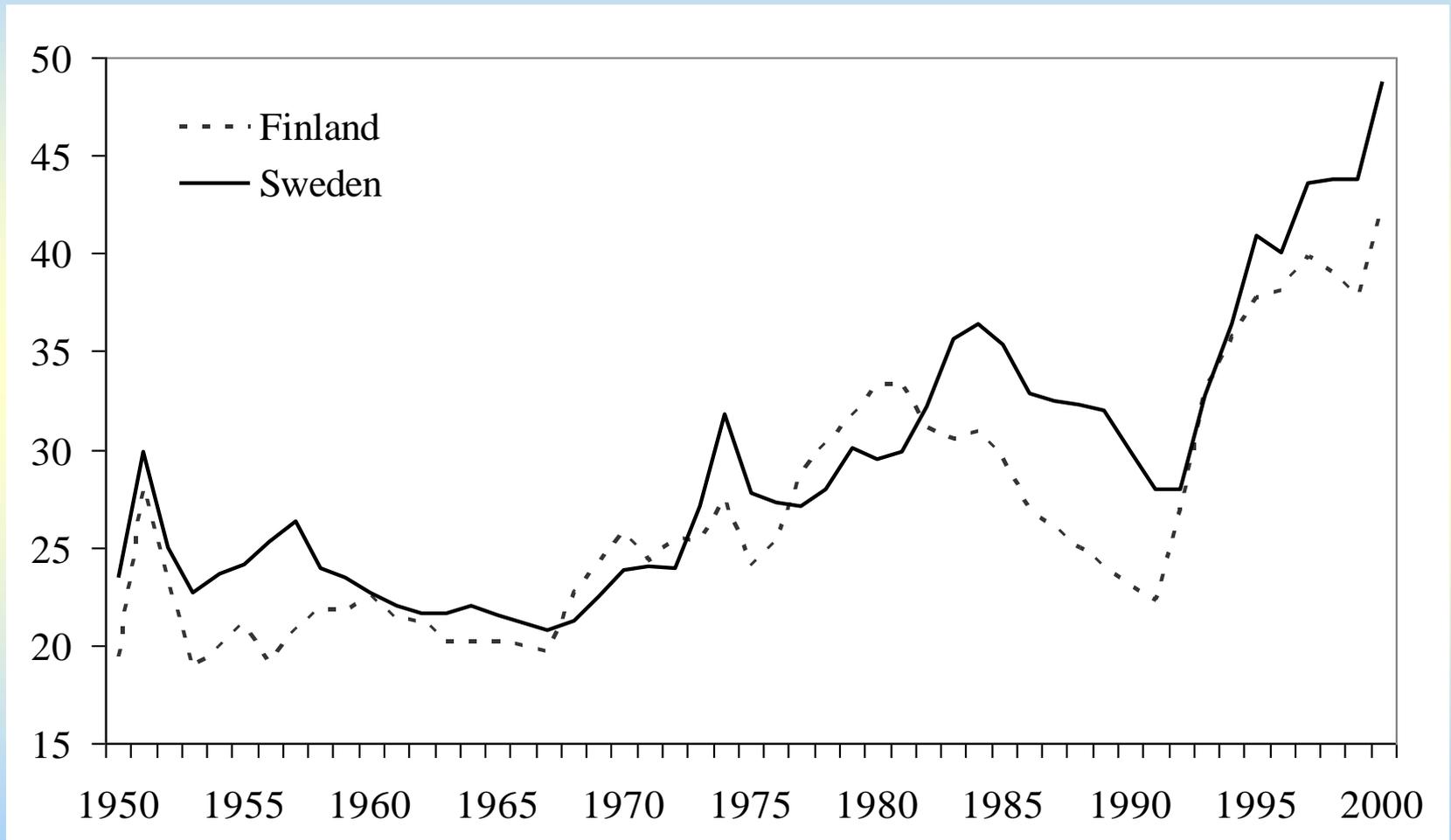
Central government debt in relation to GDP in Finland and Sweden 1980-2000. Percent.



The Finnish and Swedish exchange rate against the ECU-basket 1985-99. 1985=100



Exports in relation to GDP in Finland and Sweden 1950-2000. Percent



THE GREAT CRISIS IN FINLAND AND SWEDEN

WHY WAS THE FIXED RATE DEFENDED SO STUBBORNLY?

IN FINLAND AS WELL AS IN SWEDEN THE FIXED EXCHANGE RATE WAS STRONGLY DEFENDED DURING THE FIRST PHASE OF THE CRISIS. THE MAIN REASON BEHIND THIS DETERMINED POLICY REACTION IS THE LESSONS DRAWN FROM THE DEVALUATION POLICY DURING THE 1970S AND EARLY 1980S IN BOTH COUNTRIES. THE MAIN LESSON WAS TO AVOID A “SOFT” CURRENCY POLICY. THE COMMON OPINION AMONG ECONOMISTS AND POLICY-MAKERS WAS THAT THE DEVALUATIONS HAD NOT SOLVED THE ECONOMIC PROBLEMS IN THE LONG RUN, ONLY MASKED THEM IN THE SHORT RUN.

A FIXED EXCHANGE RATE POLICY WAS THEREFORE VIEWED AS A MORE PROMISING STRATEGY – AS A METHOD OF BREAKING AWAY FROM THE DEVALUATION CYCLE. THE IDEA WAS THAT THE PEGGED RATE SHOULD ACT AS THE ANCHOR FOR THE MONETARY POLICY AND SERVE AS THE TOOL TO ACHIEVE LOW INFLATION AND THUS CREATE A PROPER CLIMATE FOR GROWTH AND EMPLOYMENT. BOTH COUNTRIES ALSO CHOSE TO MOVE CLOSER TO THE EEC, BY PEGGING THEIR EXCHANGE RATES TO THE ECU.

THE GREAT CRISIS IN FINLAND AND SWEDEN

AN ADDITIONAL REASON WHY THE PEGGED EXCHANGE RATE WAS DEFENDED SO ENERGETICALLY WAS A COMMON LACK OF KNOWLEDGE OF THE WORKINGS OF FINANCIAL MARKETS, THE ROLE OF PORTFOLIO IMBALANCES, BOOM-BUST PATTERNS AND SPECULATIVE CAPITAL FLOWS IN A WORLD OF PEGGED EXCHANGE RATES AND FREE CAPITAL FLOWS ACROSS BORDERS.

POLICY-MAKERS AND ECONOMISTS IN FINLAND AND SWEDEN DID NOT UNDERSTAND THAT THE FINANCIAL DEREGULATION OF THE 1980S CHANGED IN A FUNDAMENTAL WAY THE PREREQUISITES FOR A FIXED EXCHANGE RATE POLICY.

THERE EXISTED NO KNOWLEDGE OF FINANCIAL AND BANKING CRISIS. THE CRISIS THUS CAME AS A COMPLETE SURPRISE TO POLICY-MAKERS, ECONOMISTS AND THE PUBLIC IN THE BOTH COUNTRIES.

THE GREAT CRISIS IN FINLAND AND SWEDEN

FINLAND AND SWEDEN CHOSE DIFFERENT EXCHANGE RATE POLICIES AT THE CLOSE OF THE CENTURY, EVEN THOUGH THE CRISES WERE BASICALLY SIMILAR IN BOTH COUNTRIES.

IN SWEDEN THE FOUNDATIONS FOR A NEW INSTITUTIONAL FRAMEWORK FOR THE MONETARY AND FISCAL POLICIES WERE LAID, BASED ON AN INDEPENDENT CENTRAL BANK AND INFLATION TARGETING.

FINLAND ABOLISHED ITS NATIONAL CURRENCY BY ADOPTING THE EURO.

HERE THE ECONOMIC TWINS PARTED FROM EACH OTHER – FINLAND OPTED FOR MEMBERSHIP IN A MONETARY UNION, SWEDEN FOR A FREELY FLOATING EXCHANGE RATE.

THE GREAT CRISIS IN FINLAND AND SWEDEN

SUMMARY:

FINLAND AND SWEDEN WERE TWO ECONOMICALLY IDENTICAL TWINS THAT FOLLOWED THE SAME PATH DURING THE LAST QUARTER OF THE 20TH CENTURY.

THEY WERE HIT SIMULTANEOUSLY BY A MOST SEVERE CRISIS

THE ANATOMY OF THE CRISIS WAS IDENTICAL IN THE TWO COUNTRIES. THE FINANCIAL DEREGULATION WHILE BOTH COUNTRIES MAINTAINED PEGGED EXCHANGE RATES DURING THE 1980S WAS THE STARTING POINT FOR THE BOOM-BUST CYCLE.

FIRST IT CONTRIBUTED TO RAPID GROWTH IN THE VOLUME OF CREDIT AND THUS TO A BOOM AT THE END OF THE 1980S. THEN, IN THE LATER PHASE, THE CREDIT EXPANSION WAS BROKEN AND BOTH THE FINNISH AND THE SWEDISH ECONOMY ENDED UP IN A DEEP CRISIS.

THE DOMESTIC CRISIS IN COMBINATION WITH THE UNREST ON THE EUROPEAN CURRENCY MARKETS BROKE THE PEGGED EXCHANGE RATE POLICY IN 1992.

THE FINANCIAL REVOLUTION UNDERMINED THE PREREQUISITES FOR A RETURN TO FIXED RATES AFTER THE CRISIS. THE ADOPTION OF INFLATION TARGETS WAS THE ONLY REMAINING OPTION FOR FINLAND AND SWEDEN.

THE GREAT CRISIS IN FINLAND AND SWEDEN

THE DEVELOPMENT OF THE REAL INTEREST RATES AND CHANGES IN ASSET PRICES AND WEALTH PLAYED A CENTRAL ROLE IN THE PROCESS OF THE BOOM AND BUST.

IRVING FISHER'S THEORY DEBT DEFLATION PROVIDES A FRUITFUL FRAMEWORK TO ANALYZE THE SEQUENCE OF EVENTS LEADING TO THE CRISIS. THE CRISIS WAS TRIGGERED BY AN INCREASE IN THE REAL RATE OF INTEREST THROUGH A RISE IN THE INTERNATIONAL INTEREST RATE LEVEL AND TIGHTER DOMESTIC FISCAL AND MONETARY POLICIES.

HIGH REAL INTEREST RATES UNDERMINED THE VALUE OF THE ASSETS OF THE HOUSEHOLDS AND CORPORATIONS, WHICH CREATED A PROCESS OF FALLING ASSET PRICES. THIS, IN TURN, LED TO SEVERE PROBLEMS IN THE FINANCIAL SYSTEM AND LARGE BUDGET DEFICITS AS THE GOVERNMENTS WERE FORCED TO SOCIALIZE THE LOSSES CAUSED BY THE DEBT DEFLATION PROCESS.

THE GREAT CRISIS IN FINLAND AND SWEDEN

AS A RESULT OF THE EXPERIENCES FROM THE CRISES, BOTH COUNTRIES REFORMED THEIR INSTITUTIONAL SYSTEMS FOR STABILIZATION POLICIES AND INTRODUCED MORE INDEPENDENT CENTRAL BANKS. BOTH COUNTRIES INTRODUCED AN INFLATION TARGET FOR THE MONETARY POLICY.

BUT IN JANUARY 1999 FINLAND JOINED THE EURO-AREA. SWEDEN HAS CHOSEN TO REMAIN OUTSIDE WITH ITS OWN INFLATION TARGET.

IT REMAINS TO BE SEEN WHETHER FINLAND AND SWEDEN – AFTER SWEDEN'S DECISION IN SEPTEMBER 2003 TO REMAIN OUTSIDE THE EURO AREA – WILL EVOLVE ALONG SIGNIFICANTLY DIFFERENT MACROECONOMIC PATHS.

A NEW AND EXCITING MACROECONOMIC EXPERIMENT

**THE GREAT FINANCIAL CRISIS IN FINLAND AND SWEDEN
IN THE 1990s.**

THE DYNAMICS OF BOOM, BUST AND RECOVERY

*Jan 08, 2011 8:00 am, Sheraton, Director's Row H
American Economic Association*

*Session: Nordic Financial Crises: Lessons from Finland, Iceland, Norway and
Sweden*

Lars Jonung, Jaakko Kiander and Pentti Vartia