THE GREAT FINANCIAL CRISIS IN FINLAND AND SWEDEN IN THE 1990s.
THE DYNAMICS OF BOOM, BUST AND RECOVERY

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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.

<table>
<thead>
<tr>
<th>Crisis years</th>
<th>Finland</th>
<th>Sweden</th>
</tr>
</thead>
<tbody>
<tr>
<td>1877-78</td>
<td>24.2</td>
<td>11.3</td>
</tr>
<tr>
<td>1907-08</td>
<td>No crisis</td>
<td>11.2</td>
</tr>
<tr>
<td>Crisis of the 1920s (1921)</td>
<td>No crisis</td>
<td>9.6</td>
</tr>
<tr>
<td>Crisis of the 1930s</td>
<td>24.3</td>
<td>17.7</td>
</tr>
<tr>
<td>OPEC I (1976-78)</td>
<td>18.7</td>
<td>9.9</td>
</tr>
<tr>
<td>OPEC II (1980-82)</td>
<td>No crisis</td>
<td>1.9</td>
</tr>
<tr>
<td>Crisis of the 1990s</td>
<td>26.4</td>
<td>13.0</td>
</tr>
<tr>
<td>W W I</td>
<td>57.8*</td>
<td>21.2</td>
</tr>
<tr>
<td>W W II</td>
<td>32.4</td>
<td>25.6</td>
</tr>
</tbody>
</table>

*Including the civil war.

Source: Hagberg and Jonung (2003).
The boom phase in Finland and Sweden 1985-90. A stylized picture.

1. Starting-point
   - A pegged but adjustable exchange rate for the markka and krona.
   - Financial regulations in force
   - Low inflation

2. Positive impulses
   - Financial deregulation in several steps
   - Capital inflows given expectations of fixed exchange rate.
   - Falling real rate of interest.
   - International boom.

3. Financial sector
   - Increasing demand for credit.
   - Increasing supply of credit.
   - Optimistic risk assessments.

4. Asset markets
   - Increasing asset prices (stocks and real estate)
   - Positive wealth effects
   - Increasing indebtedness

5. The real economy
   - Growing investments
   - Growing consumption
   - Fall in savings
   - Growing imports

6. Boom
   - Overheating
   - Appreciating exchange rates
   - Worsening current account
   - Budget surpluses
   - Expansion of the non-tradable sector
The bust phase in Finland and Sweden 1990-93. A stylized picture.

1. Starting-point
   - Overheated, "financially vulnerable economy
   - Overvalued currency
   - High inflation

2. Negative impulses
   - Speculation against the peg of the markka and the krona
   - Defense of the peg
   - Rising real rates of interest
   - Capital flight
   - International downturn

3. The financial sector
   - Decreasing demand for credit
   - Decreasing supply of credit
   - Pessimistic risk assessment

4. Asset markets
   - Declining asset prices (Stock and real estate)
   - Negative wealth effects
   - Debt deflation
   - Overindebtment

5. The real economy
   - Declining investments
   - Declining consumption
   - Rise in savings
   - Fall in imports

6. Bust
   - Banking and currency crisis (twin crisis)
   - Depression with rising unemployment
   - Budget deficit
   - Speculation- forced abandonment of the peg
   - The markka and krona floating
   - Start of recovery
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:

\[(1 - \text{tax rate on capital}) \times \text{nominal interest rate} - \text{inflation rate}.\]
Figure 9. Volume of credit in Finland and Sweden 1985-1995. Yearly percentage change.
Housing prices in Finland and Sweden
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.


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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 WERERecorded 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
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?


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 CRISIS 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.


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 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
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