Managing financial deregulation: lessons from the Nordic countries for China

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Outline

- Introduction: Financial deregulation in Europe
- Close look at the Nordic countries
- Central issues in financial deregulation
- Comments on China
- The Nordic financial crises

I. Introduction

- Destruction from the war and earlier instabilities of 1930's.
- Regulatory frameworks to protect financial services industry were kept unchanged.
  - Rationing and controls of the financial system
  - Interest rates were kept below the market levels.
  - Public debt levels were very high after WWII.
- Gradual lifting of financial controls.
  - Some marketable instruments in 1950's to 1970's (treasury bills, certificates of deposit, commercial paper)
  - Interest rate controls were gradually lifted.

- Other (gradual) developments
  - Deregulation of financial services (fees).
  - Removal of direct lending controls and investment regulations.
  - Strengthening of competition among financial institutions.
  - Financial assistance (low-rate financing, tax incentives etc.) gradually reformed or removed.
- External dimensions
  - Exchange controls, fixed exchange rates, capital controls.
  - Bretton Woods institutions:
    - IMF for loan facilities for countries in temporary difficulties.
    - OEEC (later OECD) for trade liberalization.
    - European Payment Union: clearing balances and credit.

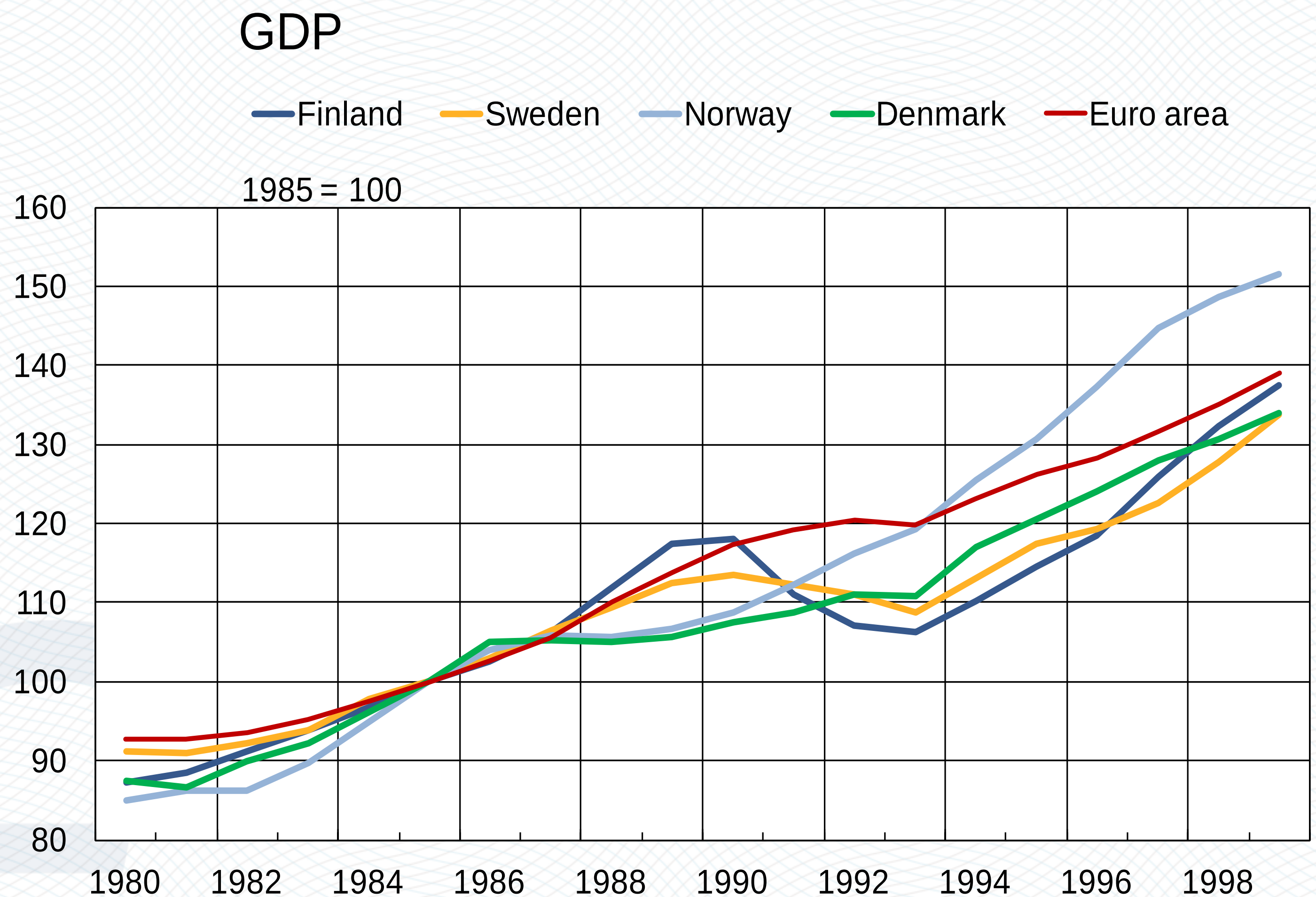
- EEC led to liberalization of real economies.
- OECD engaged countries in process of liberalization of capital movements in 1961. No without exchange controls: Canada, USA, Switzerland, Germany (after 1958).
- Breakdown of the Bretton Woods system in 1971.
  - Creation of the ’Snake’ for exchange rates in Europe.
  - The European Monetary System in 1978
  - ERM: fixed and adjustable exchange rates, mutual support.
- Renewed efforts to capital account liberalizations in 1980’s.
  - EU: some countries (Germany, UK, Denmark) liberalized before 1986 EU Directive, Netherlands later in 1986. France in 1988.

- Maastricht Treaty in 1992 made free movement of capital a cornerstones of EU.
  - EMS crisis in 1992-93 led to realignments and wide bands for exchange rates.
  - Road to EMU (started in 1999). New ERM for outsiders. Also floaters (Sweden, UK…)

- Liberalization of banking and financial systems
  - Timing of domestic liberalization varied among countries.
  - EU legislation: important steps from 1989 onward.
    - Single EU banking licence,
    - Single passport for investment services,
    - Single market in financial services etc.
- ♦ Banking crises in Europe (before the current one):
  - Problems with individual banks: BCCI, Banesto, Barings, Credit Lyonnaises and various small banks.
  - Systemic banking crises: 3 Nordic countries in early 1990’s and Spain in early 1980’s
    - among the ”big five crises” of advanced market economies before the current crisis (Reinhard & Rogoff)

II. Close look at the Nordic countries

- Why important?
  - Three out of four countries developed very big financial crises from liberalization.
- Background on Nordics:
  - Small open economies, total population over 22 million:
    - Wide-spread ties, e.g., common labor market since 1954.
    - Sweden wealthiest in 1970s, Finland weakest (suffered heavily in WWII).
    - Foreign trade and associated payments liberalized early by the end of 1950's.
  - Egalitarian, socially cohesive countries with democratic tradition:
    - Big public sector, strong influence on the economy.
  - Financial repression was an instrument of growth and industrialization policies.
    - More rapid inflation than in much of the western world.



Source: Eurostat.

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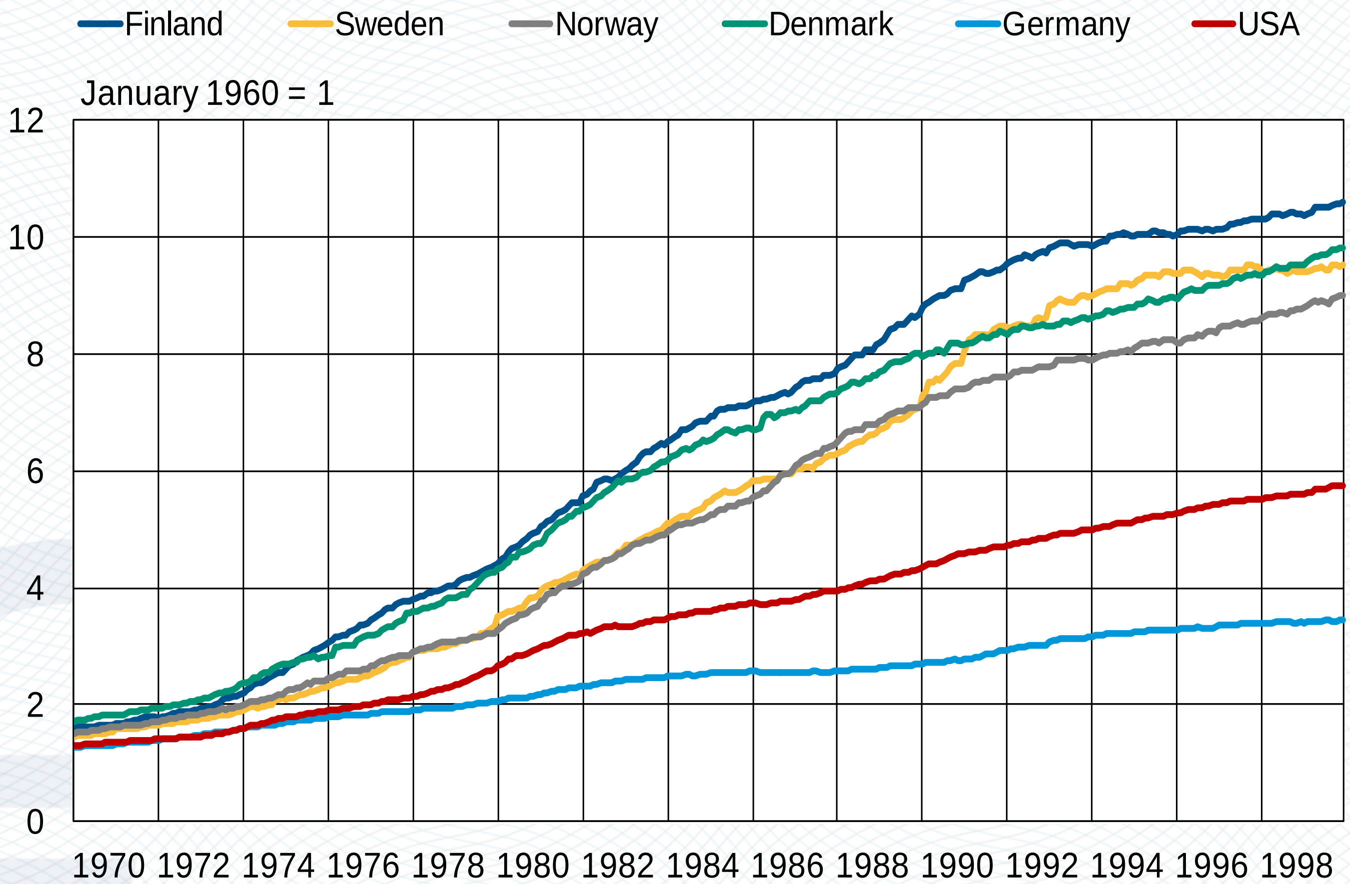
Consumer prices



Source: OECD.

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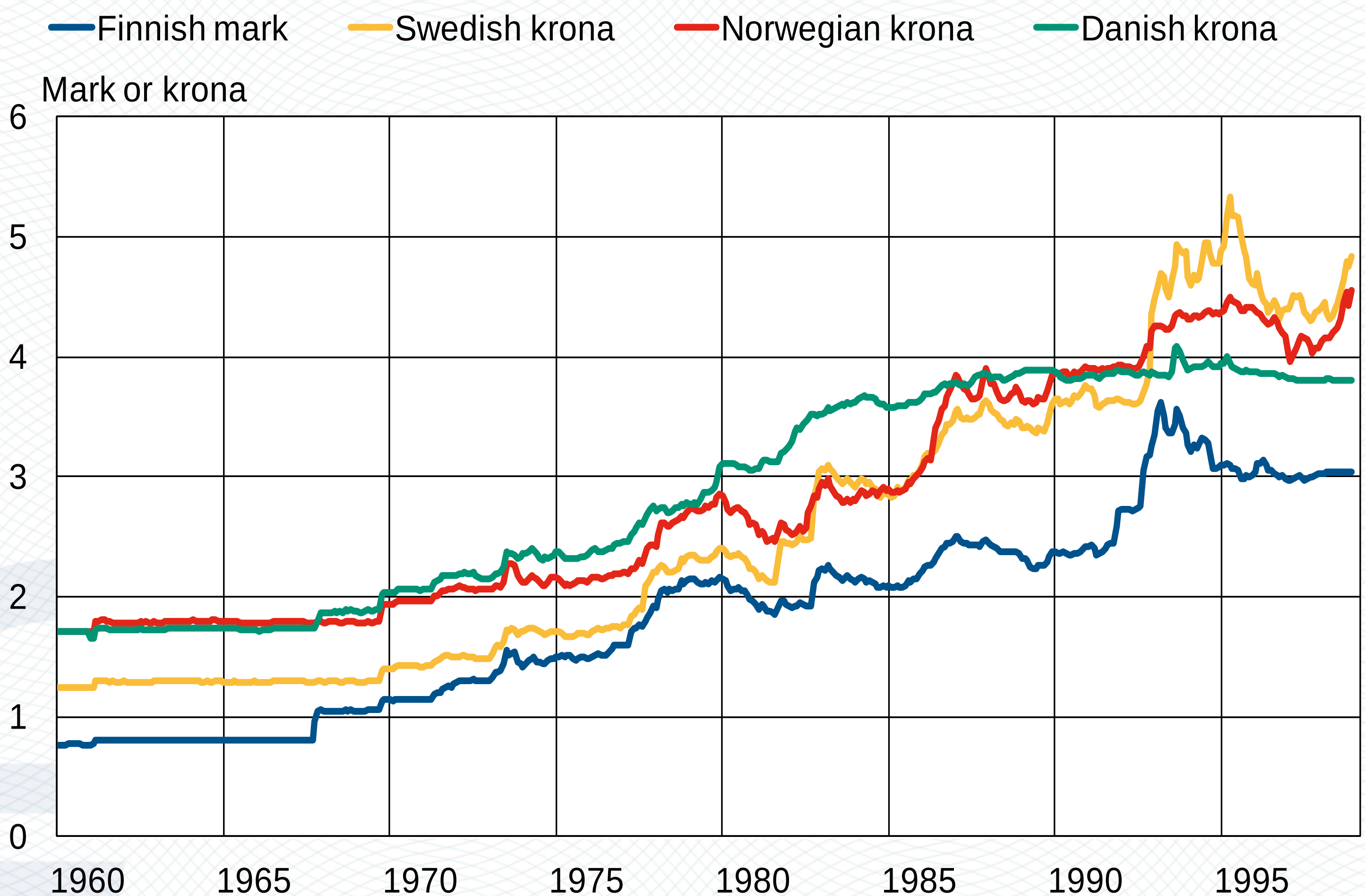
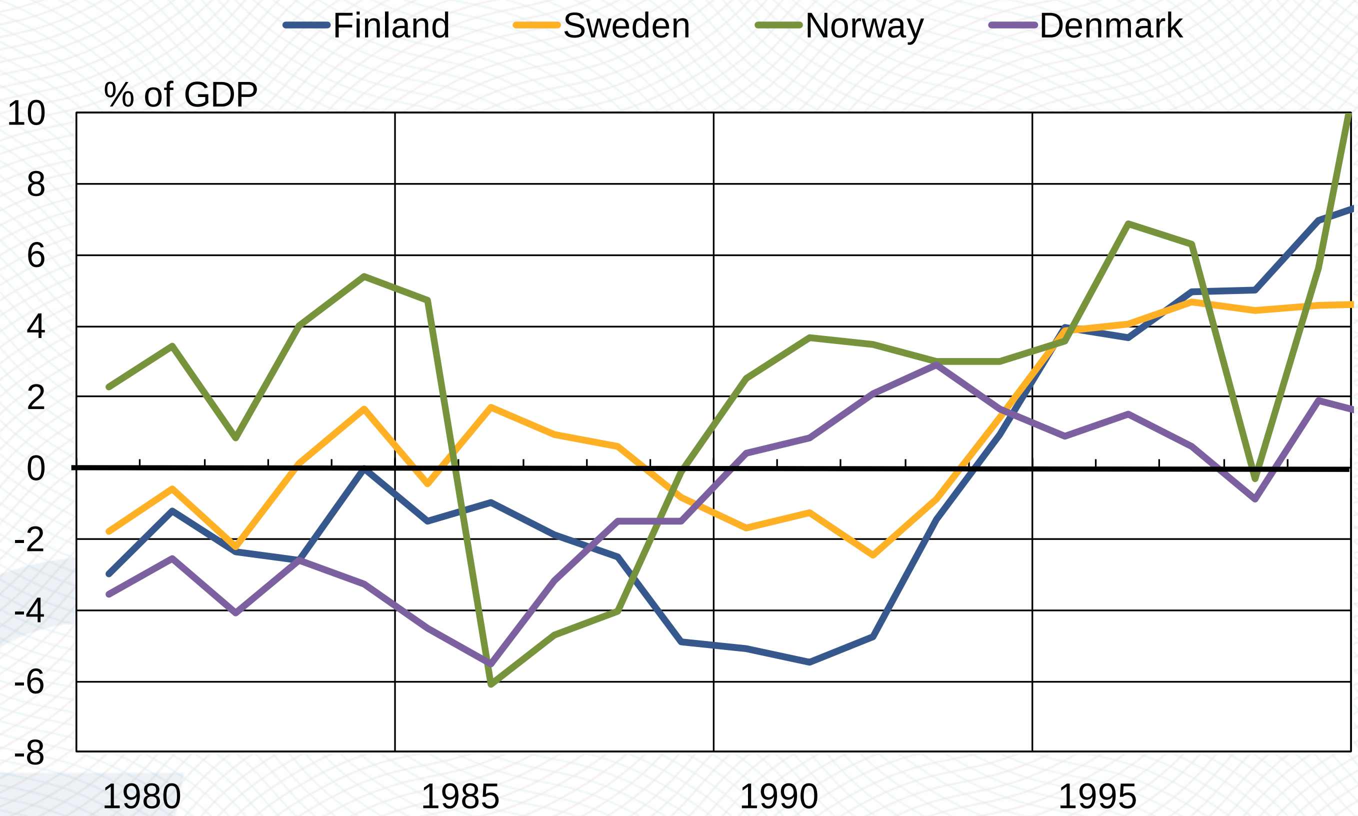
Nordic currencies against German mark



Source: Bank of Finland.

Current account



Source: European Commission.

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II.1 Nordic financial systems in early 1980's

- Denmark had a more liberal system.
  - Details will not be discussed.
- Financial systems were tightly controlled:
  - Interest rate controls by the Central bank.
  - Central Bank controlled credit flows in the economy.
  - Capital controls.
- Banking system dominated by a few large banks and many smaller banks.
  - Mostly private ownership of banks,
    - capital largely raised from the private sector
  - Banks rationed credit to households and firms.

- Exchange rates pegged to currency baskets.
- Capital account controls:
  - Permits for long-term movements,
  - no short-term financial movements,
  - Foreign trade finance relatively free,
  - Foreign exchange for travel rationed.
- Non-bank systems:
  - Stock, bond markets and insurance sector kept small,
  - no major non-bank intermediaries (except special finance companies),
  - activities of foreign banks very restricted.
- Supervision focused at compliance in lending and accounting, no risk supervision.

- Competition restricted by regulation of interest rates, entry into financial market, etc.
  - Also new bank branches restricted.
  - Subsidiaries of foreign banks not allowed.
- Strong legal system (”Rule of law”)
  - e.g. bankruptcy procedures.
- Very stable banking systems:
  - Very low loan losses,
  - inefficiencies: large personnel and branch networks.
- Tight controls protected independent monetary policy.

II.2. Main aspects of Nordic deregulation

- Growth of international trade and internationalization of firms.
  - This created pressures for liberalization.
- Growth of international financial markets.
  - IMF, OECD, EU sought liberalizations of markets and capital flows.
- Leakages and loopholes in the controls emerged.
  - ”grey” domestic financial intermediation in late 1970’s and 1980’s.
- Liberalization involved numerous individual acts
  - see slide for Finland.
  - Volatility in macroeconomic developments from the liberalization.

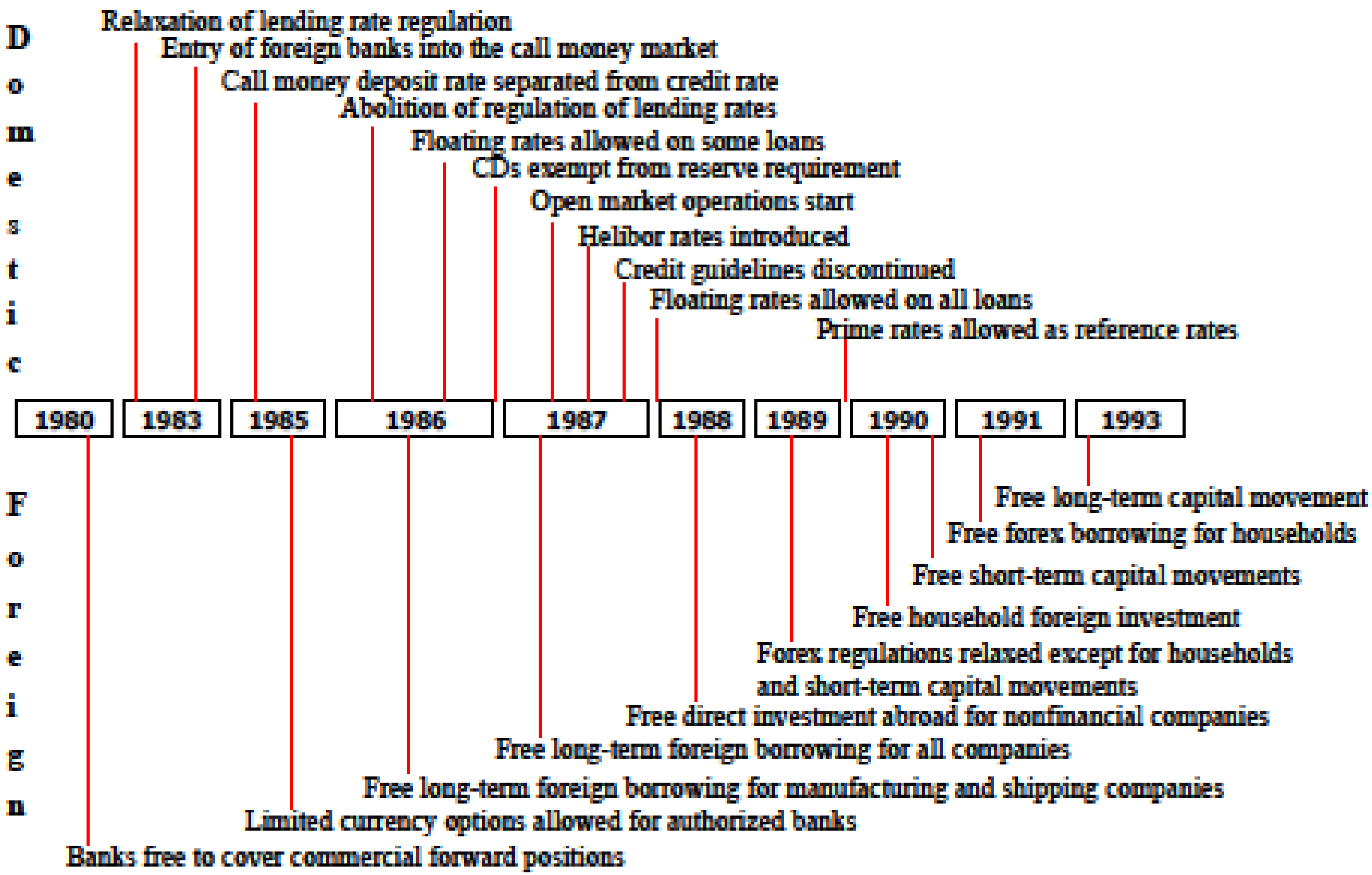


Chart 3B. Deregulation of financial markets in Finland

Source: Englund & Vihriälä (2003)

III. Central issues in financial deregulation

- Liberalization of financial and foreign exchange markets limits the leeway of domestic economic policy.
- **Impossible trinity:** with free markets one cannot fix exhange rate, domestic interest rate, and quantity of finance.
- Order of liberalization:
  - Domestic market before international capital movements or vice versa?
  - Which order for different markets in terms of maturity, sector finance, derivatives etc.

- Other issues:
  - Which order for currency denomination (domestic vs. foreign)?
  - Which order for exports and imports of capital?
  - Should there be response to market pressure?
  - When might deregulation steps be reversed?

- Nordic countries liberalized domestic and currency markets and capital movements in tandem.

- Decisions about taxation of finance:
  - Is debt finance favored?

III.1 Problems in Nordic liberalizations

- Bad timing, espec. for Sweden and Finland
  - big steps in 1985-86, at the time business cycle turning upward.
  - Collapse of OPEC cartel -> lower oil prices. (Norway)
- A boom developed in Sweden and Finland.
  - It turned into a systemic banking, currency and economic crisis at the start of 1990's.
    - Collapse of Soviet Union was a big shock for Finnish exports.
    - Norway experienced only a banking crisis.
    - Denmark had banking problems but no systemic crisis.
- Other problems:
  - Narrow focus on executing the acts of liberalization was insufficient.
  - There was little aid to markets, firms, households and banks in adjustment toward competition with flexible prices.

- Problems continued:
  - Very little realization that liberalization to market-based finance implied increased risks.
    - Risk management viewpoint became important for banks.

- No reform of financial regulation:
  - Not only compliance regulations,
  - risk assessments and systemic viewpoint were missing.

- Macroeconomics:
  - The fixed exchange rate systems came under pressure.
  - Nordics moved to floating of Forex rates in 1992 and adoption of inflation targeting.

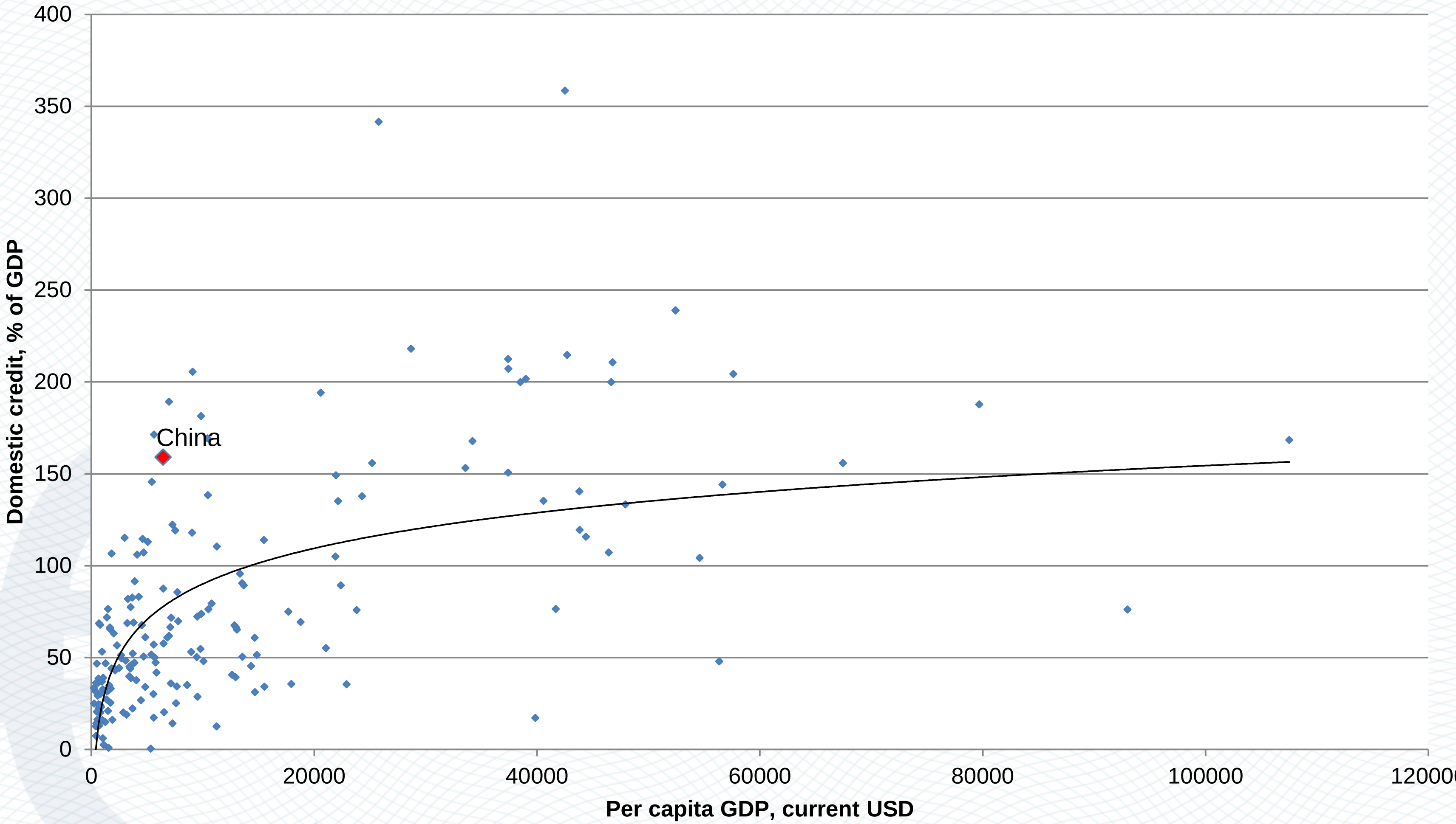
III.2 Lessons

- Dangers from lack of financial knowledge
  - Traditional way of thinking becomes a trap.
  - This reform is much more than technical adjustments.
- ♦ A cautious and gradual approach is probably better than a 'big bang'.
- ♦ Important to time well acts of liberalization:
  - To avoid pro-cyclicality.
  - Strengthen capital ratios of banks well before.
  - Reform the supervisory system in advance.

- Macroeconomic aspects:
  - Make exchange rate flexible before opening capital movements.
  - Reforms for the taxation system.

- Liberalization has long-run benefits for growth and development.
  - But there are limits. A fully laissez faire financial system is likely to be unstable.

IV. Comments on China:
a large banking sector



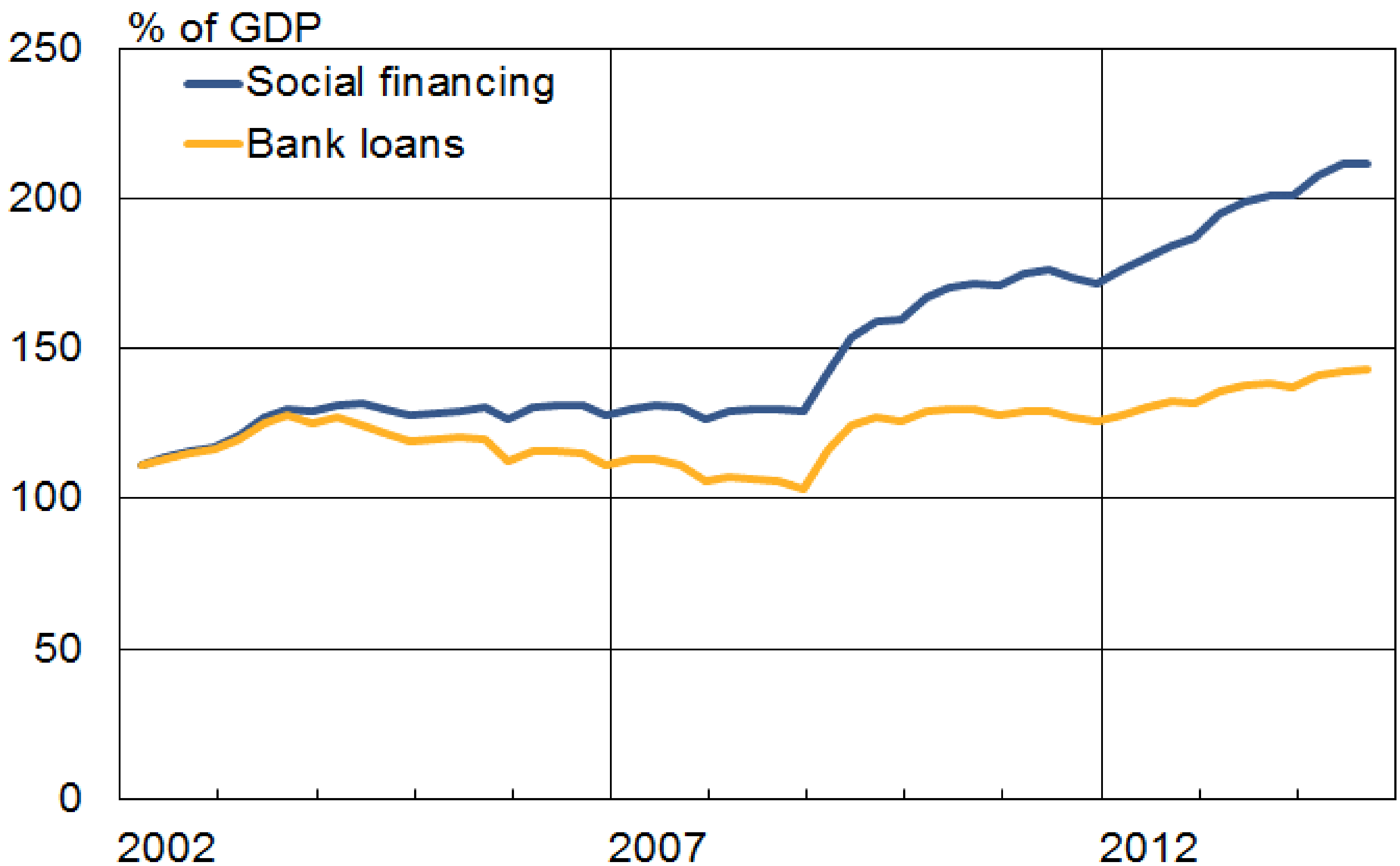
Source: World Bank Development Indicators

- After 2001 gradual measures to reform and open up the financial sector.
  - More flexibility to interest rates
  - Security markets opened up to foreigners (QFII)
  - Access to foreign markets for domestic investors (QDII)
  - Offshore market in Hong Kong
  - Tight peg to US dollar loosened somewhat
- Regulatory system strengthened in 2003.
- More reforms during the financial crisis in 2008.
  - Yuan used in trade settlements
  - More opportunities to invest to and from China

Banking sector liberalization continues in small steps

- In 2013 lower limit on banks’ lending rate removed
- On November 21, banks allowed to offer 20% higher deposit rates than the benchmark rate (up from 10%)
- Preliminary information concerning introduction of deposit insurance, ceiling €65.000, covers more than 99% of all deposits
- Big state banks still dominate the market, in Q1/14 they constituted 43% of total banking sector balance sheet, down from 52% in 2008

”Shadow banking” in China very much linked to banks, and driven by slow liberalization



Source: Macrobond

Shadow banking

- Various products, often marketed by banks, but off their balance sheets:
  - entrusted loans, wealth management products, money market funds etc.
- For example, Alipay's **Yu'E Bao** money market fund attracted more than 1% of household deposits in less than a year;
  - this MMF is similar to demand deposits in many aspects
- Investors have access to much higher yields than traditional bank deposits.
  - Much less transparency about risks than in the traditional banking sector; are risks understood?

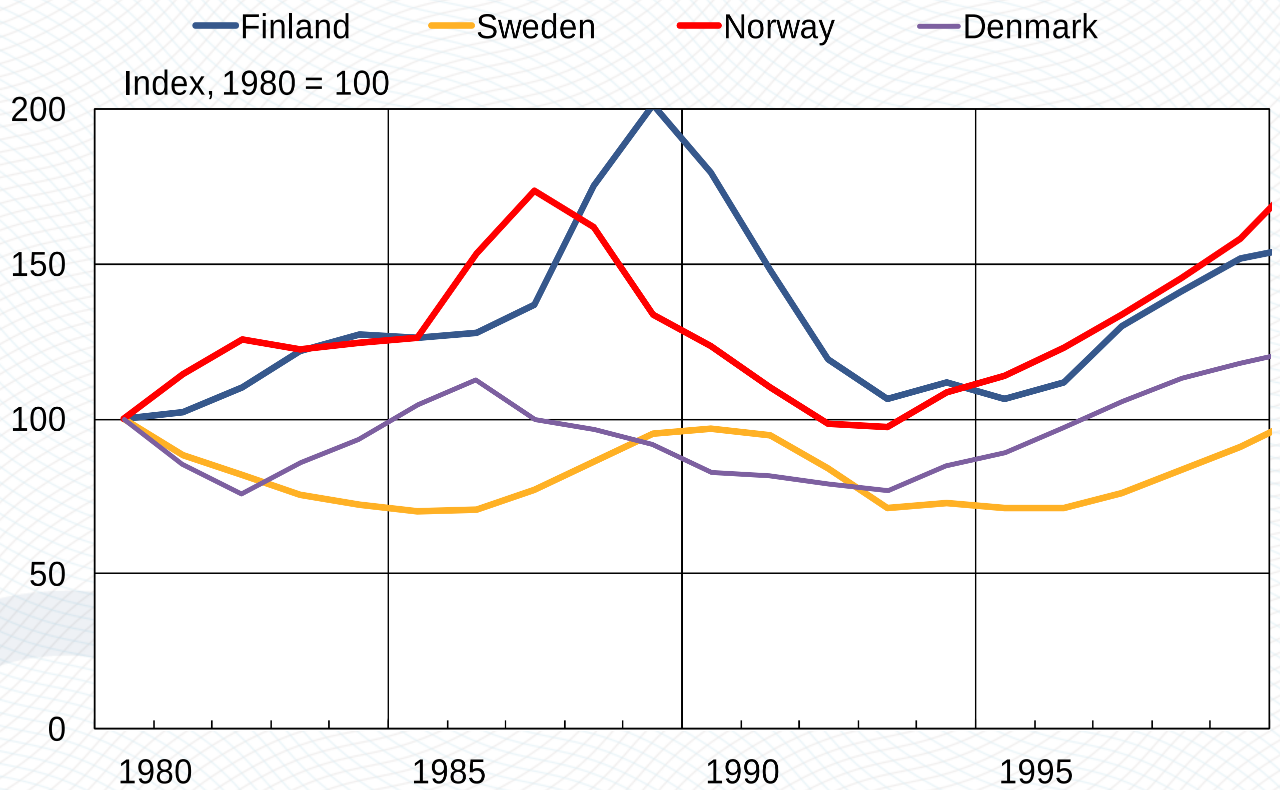
Capital account liberalization taking small steps forward

- Various quotas have been introduced and expanded.
- Link between Shanghai and Hong Kong stock exchanges.
  - the initial trading volumes have been smaller than expected.
- Great reluctance to liberalize capital flows significantly until domestic financial system has been liberalized more.

V. The Nordic financial crises

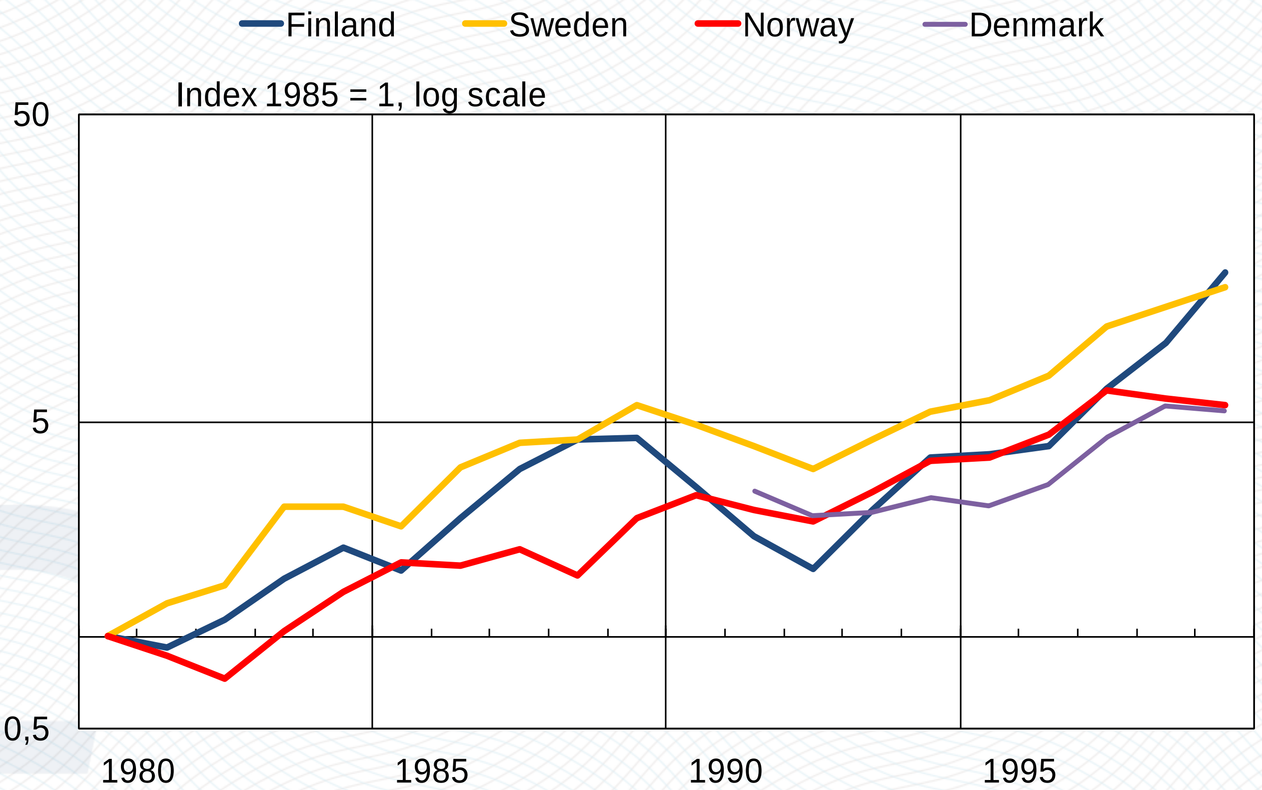
- In case a financial crisis emerges:
  - Take swift action to maintain stability and confidence of the banking system.
  - Contain moral hazard when dealing with banking crisis.
- At the start of 1990’s the boom turned into systemic banking, currency and economic crisis.
  - Denmark had banking problems but no system crisis.
  - Norway experienced only a banking crisis.
  - Finland experienced a big shock in exports.

Real house prices



Nominal house prices deflated using the consumer price index.
Sources: Statistics Finland, Statistics Sweden, Norges Bank, Statistics Norway and Bank of Finland. 25125@Chart4_2 (en)

Real share prices



Nominal share prices deflated using the consumer price index.
Sources: IMF, ECB and Bank of Finland.
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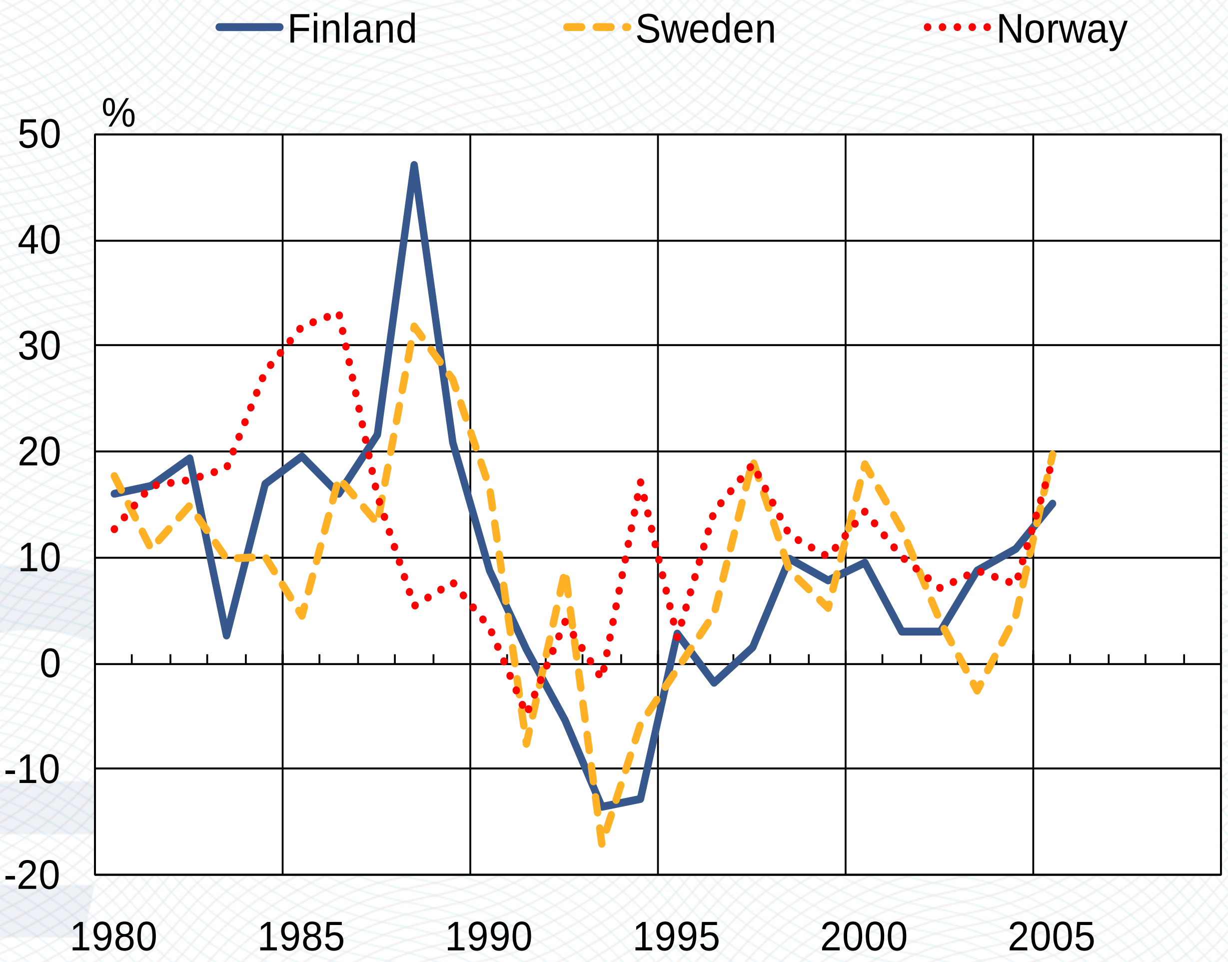
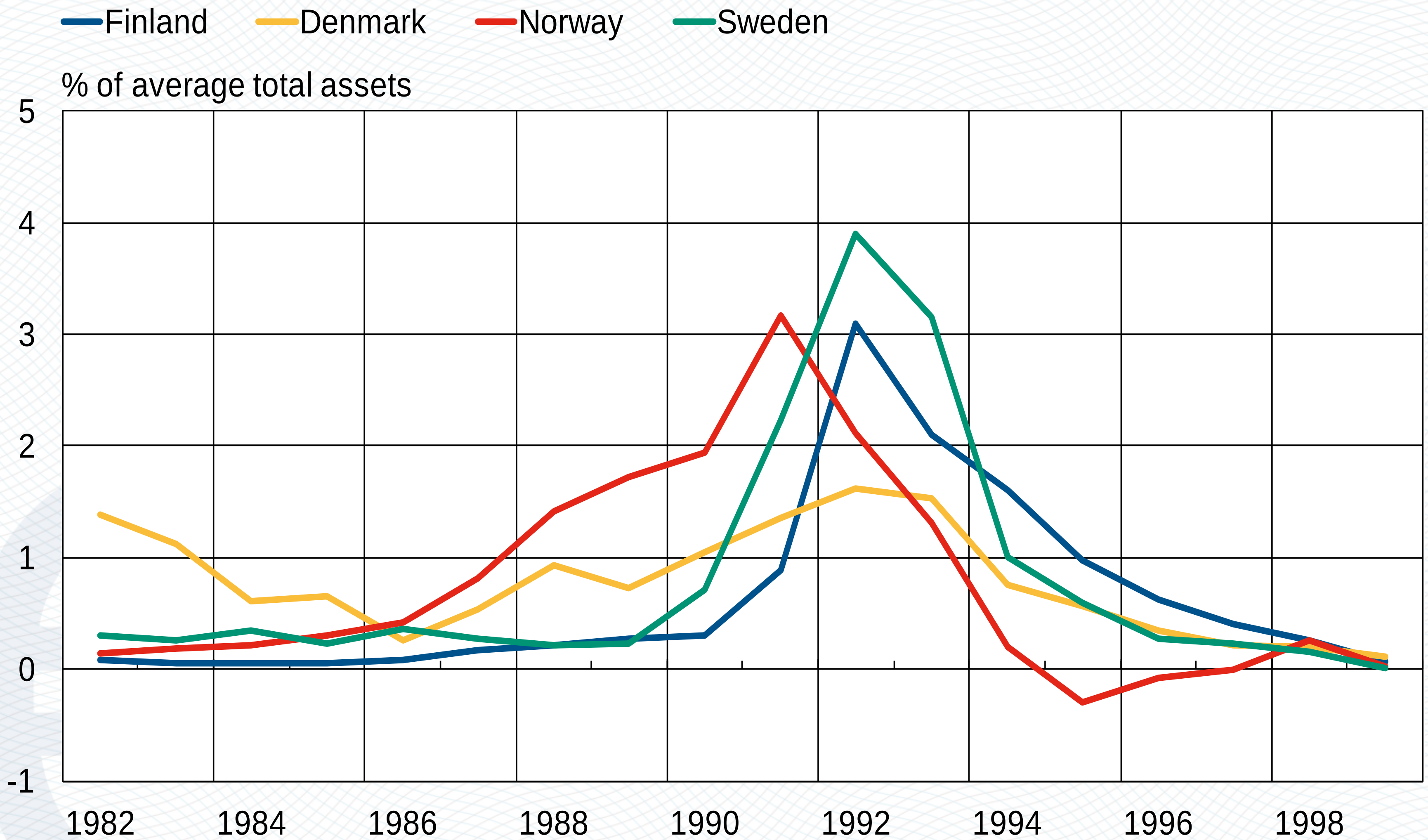
Figure 6. Lending growth



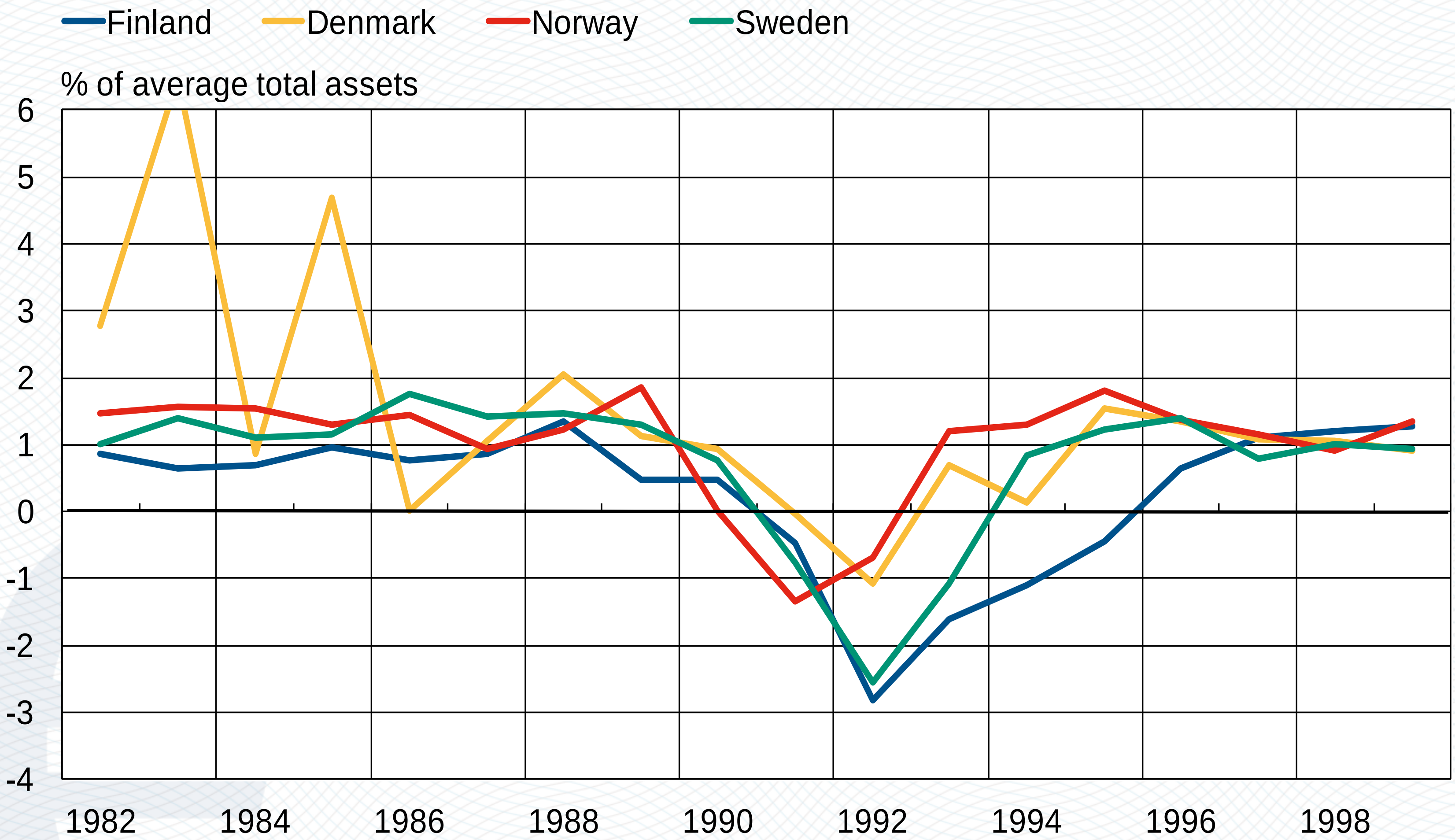
Sources: OECD and Bank of Finland.

Nordic banks' loan losses



Source: National central banks.

Nordic banks' operating profits



Source: National central banks.

V.1 Crisis management

- **Finland**
  - 1st measure: Bank of Finland took control of Skopbank in September 1991.
  - Government set up the crisis management agency.
  - Public support: preferred capital certificates to banks, with strict requirements.
  - Policy-makers made promises to guarantee banks' obligations, also further public support.
  - Support to be converted into shares if not repaid.

- Finland (continued)
  - Banks became profitable again in 1996
  - Improved efficiency (staff was halved, etc.)
  - Major restructuring of banking system:
    - savings banks largely disappeared,
    - one big commercial bank was merged to another.
  - Nowadays 60 percent of banks owned by foreigners

Sweden

- Mergers and recapitalizations of banks, blanket guarantees.
- Crisis resolution agency set up, public support with strict criteria in risk reduction and efficiency.
- Some banks did not need public support.

$\Rightarrow$ In the end nearly all support went into two banks, Gotabanken and Nordeabank.

- Nordeabank became a pan-Nordic bank ”Nordea”.

- **Norway**
  - Crisis erupted in autumn 1988.
  - Initially private guarantee funds used but were exhausted. Government guarantee funds set up in early 1991.
    - Capital support for solvency.
  - In Spring 1992 several banks, incl. three biggest commercial banks were nationalized.
  - Specific announcements about securing depositors and creditors.
  - One of nationalized banks was sold in 1995 and two other banks were sold later.

    => In the end the Norwegian tax payer made money out of the crisis (not so in Finland and Sweden).

	Gross cost	Net cost
Finland	9.0 (% of 1997 GDP)	5.3 (% of 1997 GDP)
Norway	2.0 (% of 1997 GDP), 3.4 (present value , % of 2001 GDP)	-0.4 (present value, % of 2001 GDP)
Sweden	3.6 (% of 1997 GDP)	0.2 (% of 1997 GDP)

V.2 Lessons

- ♦ **Prevention of major crisis** is the first priority.
- How to diagnose an overheating situation?
  - rapid credit expansion
  - strong increase in leverage
  - big external deficits in open economies
- ♦ Political-economy reasons can be a major obstacle in crisis prevention.
- Crisis management:
  - Maintaining confidence in banking system is crucial.
- Role of central banks:
  - Liquidity support in Norway and Sweden.
  - Bank of Finland had to take over a problem bank.

- ♦ Crisis resolution agencies in all three countries
  - Separation from central bank and ministry of finance,
  - capital injections to banks,
  - guiding the restructuring of the banking system,
  - Treatment of ”old shareholders” was mixed.
- Asset management companies (”bad banks”) to deal with non-performing assets.

=> Nordic practices in crisis resolution have been praised afterwards.

Thank you !

For more detailed discussion see:

- Honkapohja, S., 2014. Lessons from the Financial Liberalization in the Nordic Countries in the 1980s, in Woo, W.T., Pan, Y. , Sachs, J., Qian, J. (Eds.), *Financial Systems at the Crossroads*, World Scientific Publishing, Singapore, pp.135-163.

- Honkapohja, S. 2014. Financial Crises: Lessons from the Nordic Experience, *Journal of Financial Stability*, vol.13, August, 193-201.