Lessons in Financial Liberalization for China from the Financial Market Collapses in Finland and Sweden in the 1990's*

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* Views expressed are my own and do not reflect possible views of the Bank of Finland

Outline

- European financial integration since the 1970's
- Financial liberalization in Europe
  - Nordic countries are a key story: big crises
- Similarities and differences to China
- Overview of Nordic liberalization
  - Lessons for China?
- Lessons from the creation of euro?

European financial integration since the 1970’s

- The monetary system in Europe
  - Breakdown of Bretton Woods system in 1971 => creation of the ’Snake’ for exchange rates in 1972
    - EU currencies within a tunnel of 4.5% against USD
  - The European Monetary System in 1978
    - ERM: fixed and adjustable exchange rates with mutual support
    - Big inflation differentials => realignments
  - Few realignments after 1986 until the EMS crisis in 1992-93.
    - Wide bands in ERM as response.
  - Road to EMU, which started in 1999.
    - New ERM for outsiders

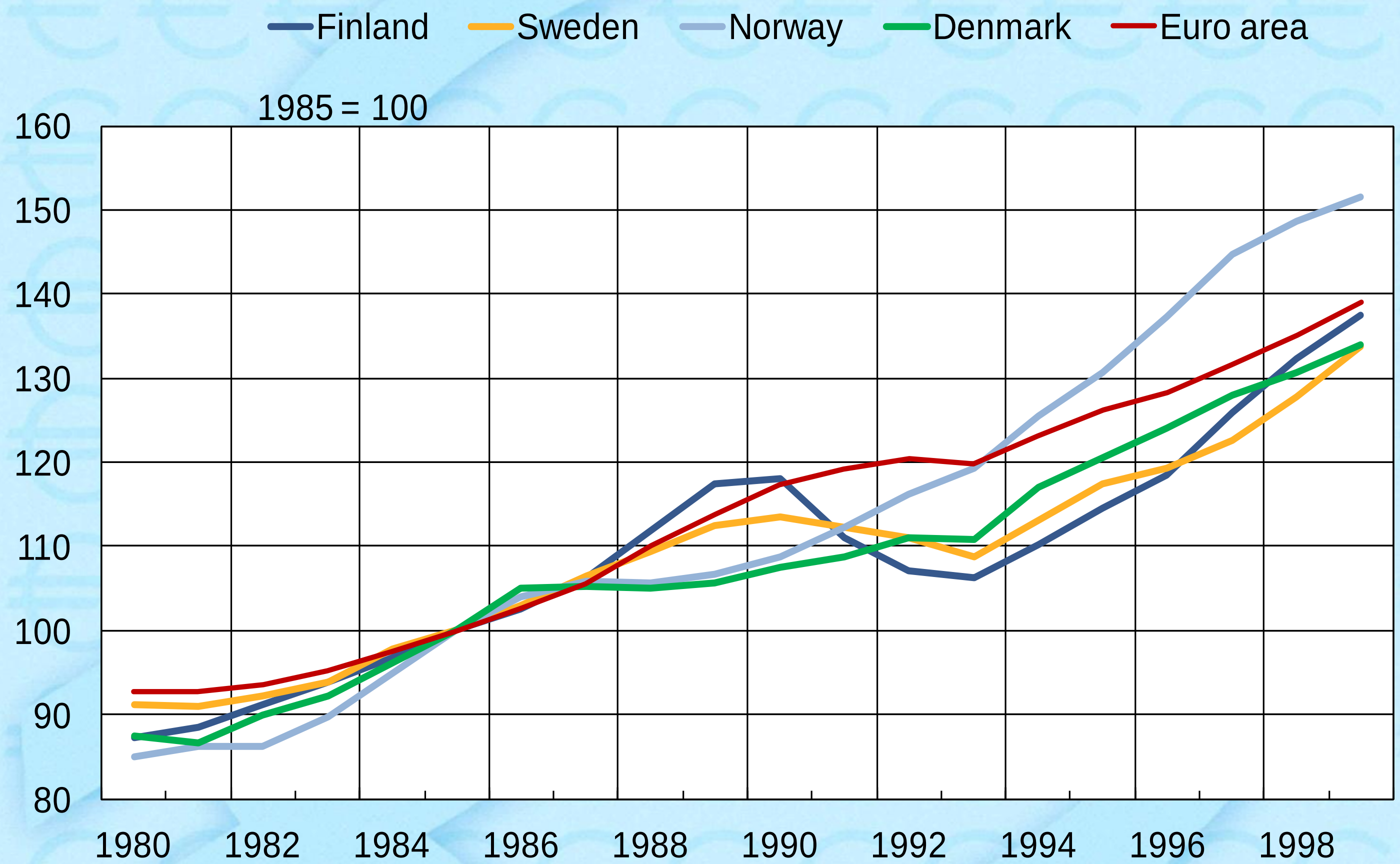
- ♦ Liberalization of banking and financial systems
  - – Timing of liberalization varied in the 1960’s- 1980’s
  - – EU legislation, important steps from 1989 onward
    - Single EU banking licence,
    - Single passport for investment services,
    - Single market in financial services etc.
- Rapid change and growth of the financial sector:
  - – Expansion due to deregulation and the EU Single Market Program.
    - Banking assets/GDP in big EU countries rose from 175% (in 1984) to 283% (in 2004).
  - – Relative decline in traditional banking (deposits, lending)
- Banking crises in Europe in the 1970’s – 1990’s
  - – Problems with individual banks:
    - four big banks 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

- ♦ Emergence of Pan-European Banks put strains on the supervisory framework.
  - – Supervision relied on national responsibilities.
  - – Home country supervision is difficult for small countries that must deal with large banks.
  - – Host country principle runs into practical problems
    - Potentially large number of relevant supervisors.
- ♦ The EMU started in 1999 and deepened financial integration further.
  - – I will not discuss it further.

The Nordic countries since 1970s

- 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.
- The next slides give the basic data (GDP, consumer prices, exchange rates, current accounts)

GDP



Source: Eurostat.

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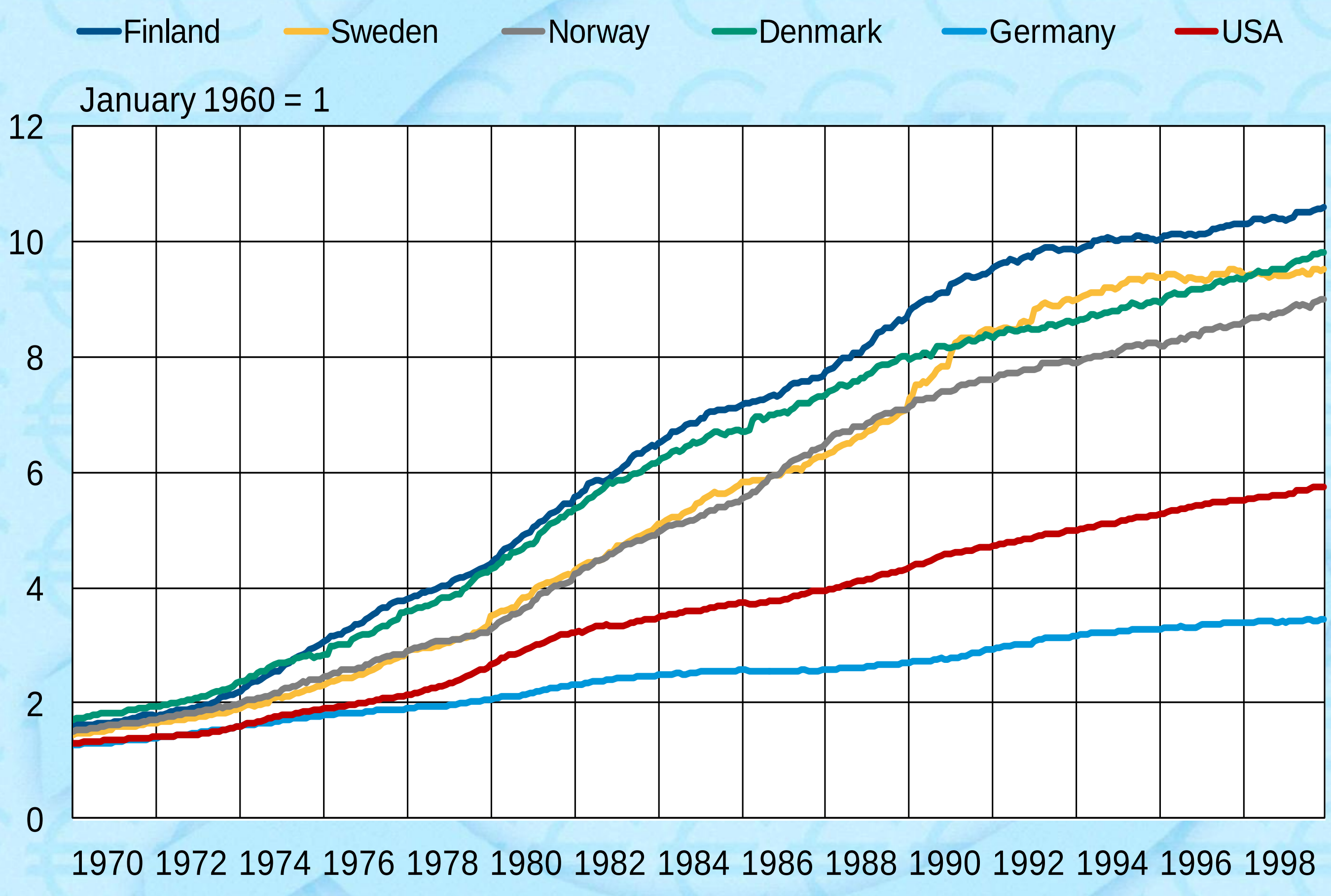
Consumer prices



Source: OECD.

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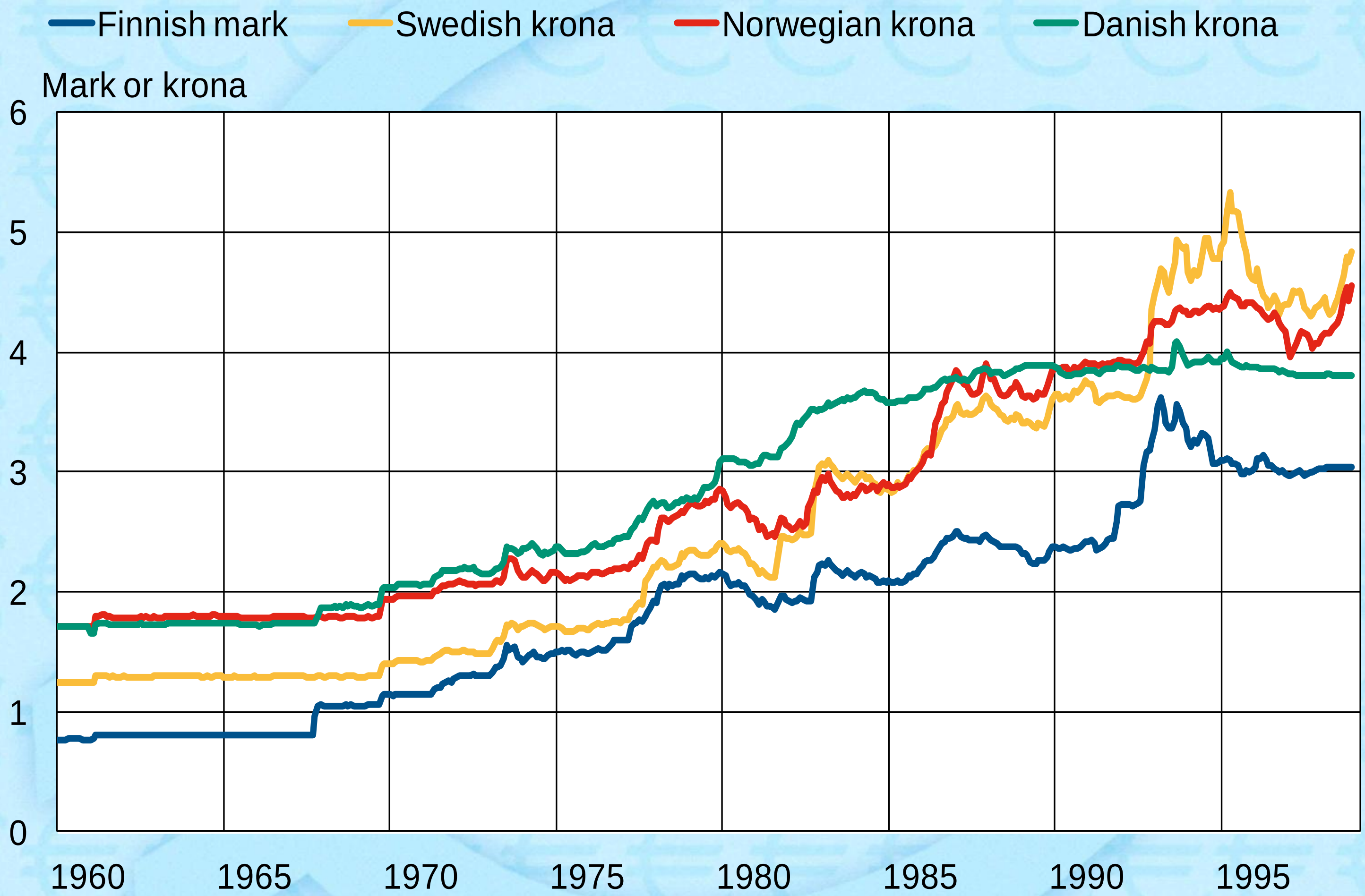
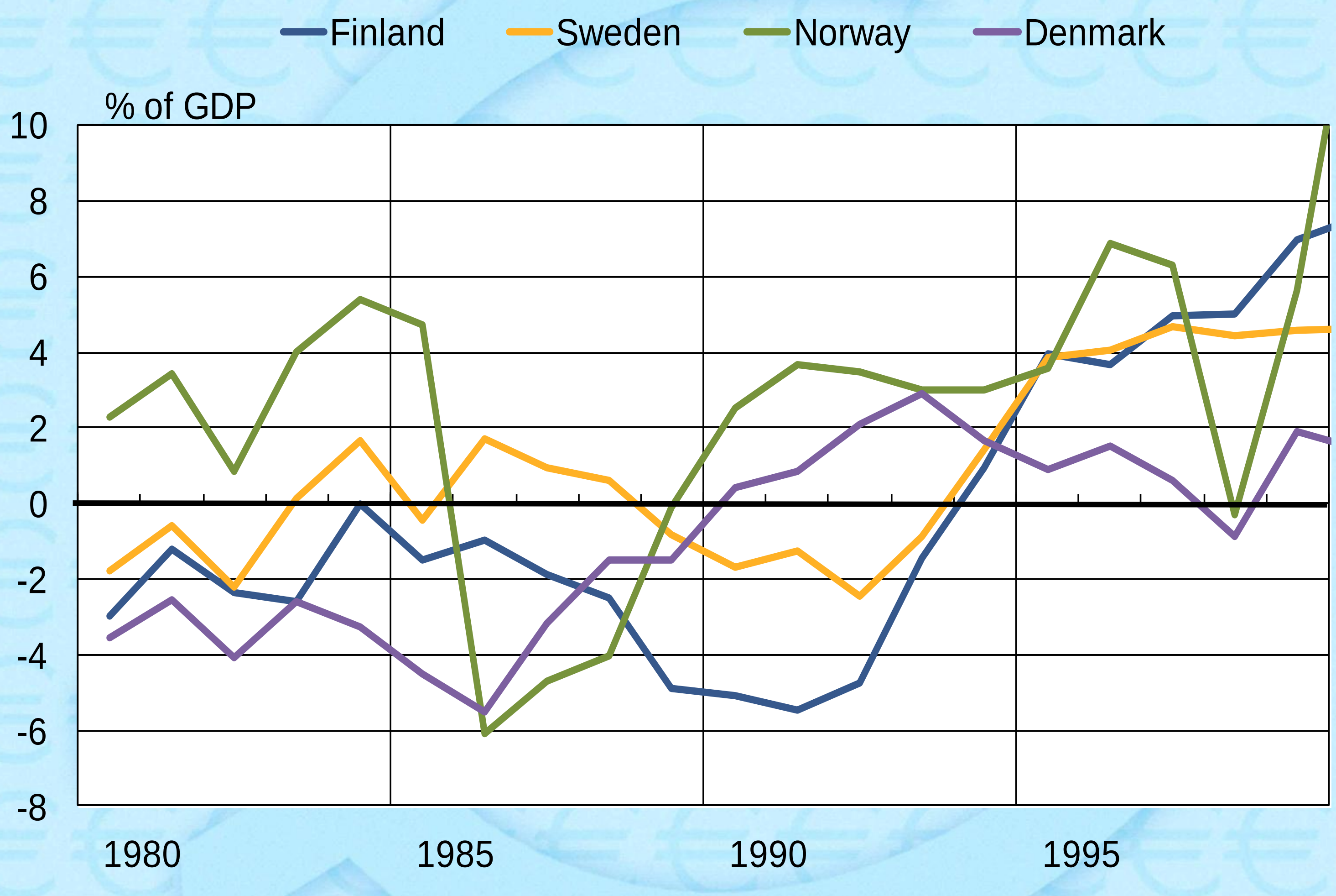
Nordic currencies against German mark



Source: Bank of Finland.

Current account



Source: European Commission.

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Nordic financial systems in early 1980's

- Denmark had liberalized gradually in 1970's onward.
  - Stronger capital ratios for Danish banks were introduced.
  - Details will not be discussed.
- Financial systems were tightly controlled:
  - Interest rate controls by Central bank.
  - Central Bank controlled credit flows in the economy.
- 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,
  - Fx 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 control of lending and accounting, no risk supervision.

- Competition restricted by regulations 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 in place
- Very stable banking systems:
  - Very low loan losses,
  - Inefficiencies:
    - large personnel and
    - big branch networks.
- Tight controls to protect independent monetary policy.
  - Low interest rates to stimulate economic growth
  - Policy led to high investment rates (e.g. 25-30% earlier for Finland)

Aspects of the current financial system of China

- Banking dominated by 4 state-owned banks
  - Non-state banks since 1996
- Stock market emerging, big role of state-owned companies
  - bond market still small
- Gradual improvement in prudential supervision:
  - new regulators, BIS framework for solvency, international accounting standards
- Little/no competition legislation, gradual lifting of limitations on competition.

- Weak enforcement of bankcruptcy and of creditor rights.
- Central of role of the state in commercial decision making.
- Repeated recapitalization by state of big banks.
- Partial liberalization of interest rates with floors and caps.
- Crawling peg in exchange rates.
- Gradual relaxation of capital controls.

- It must be emphasized that the Chinese economy is going through a lot of changes in features lisated above.

1980s Nordics and present China compared

- Both fairly open economies with open current accounts.
- Size difference huge.
- China is less advanced in terms of economic development:
  - Large state-owned sector with soft budget constraints
  - Relative GDP about 1/8 [PPP adjusted, 2008]
  - much higher income inequality
- Risk of social tensions from reforms in China.
- Macroeconomic development in China favorable:
  - Growth rate, strong government revenues
  - Higher credit-GDP ratio in China

Main aspects of Nordic liberalization

- Fundamental driving forces in the backgrpound:
  - Growth of international trade and internationalization of firms.
    - This created pressures to liberalize.
  - 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 involves numerous acts
  - see next 2 slides about Sweden and Finland (source: Englund & Vihriälä 2009).
- Some volatility in macroeconomic developments during liberalization.

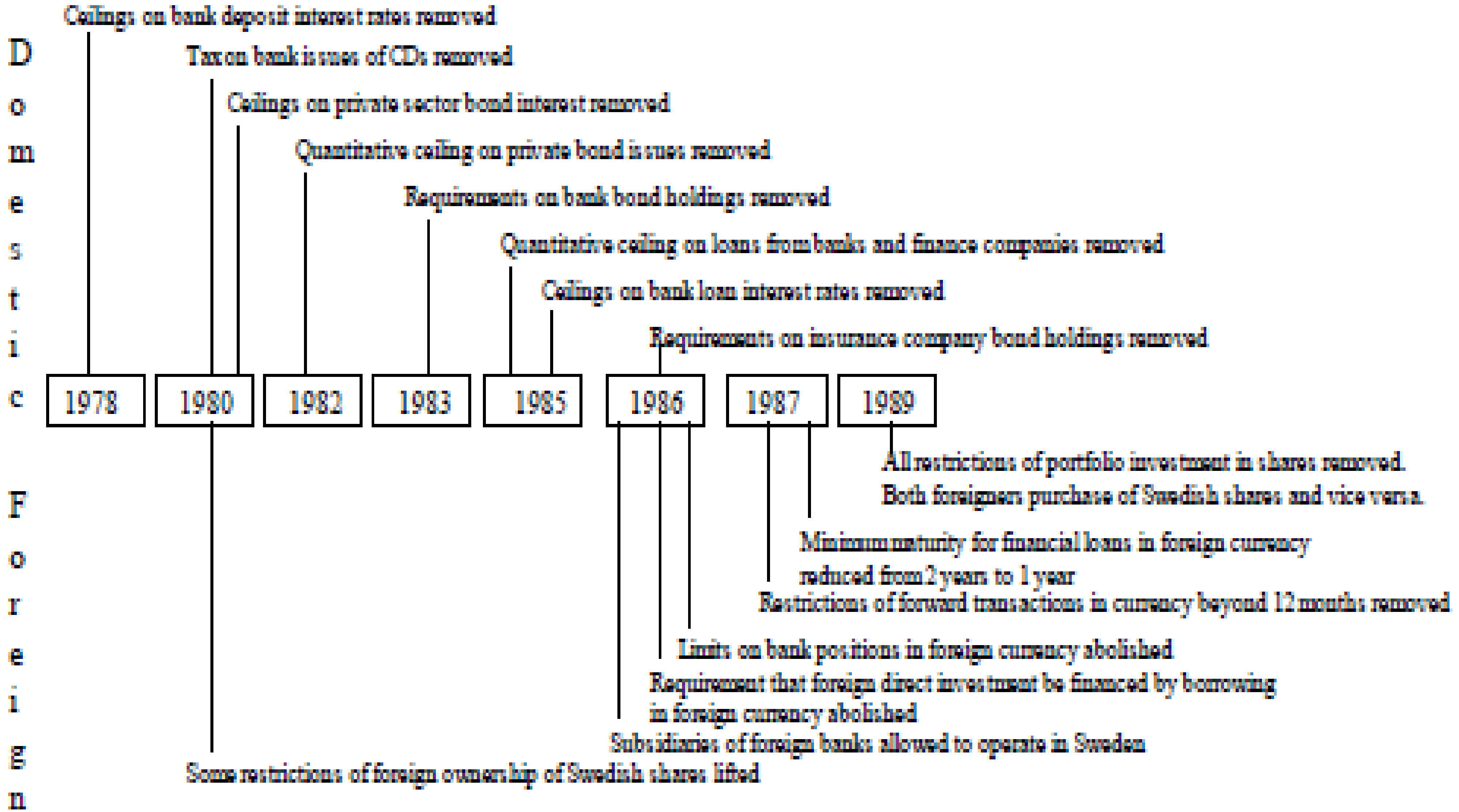


Chart 3.4. Deregulation of financial markets in Sweden

Source: Englund & Vihriälä (2003)

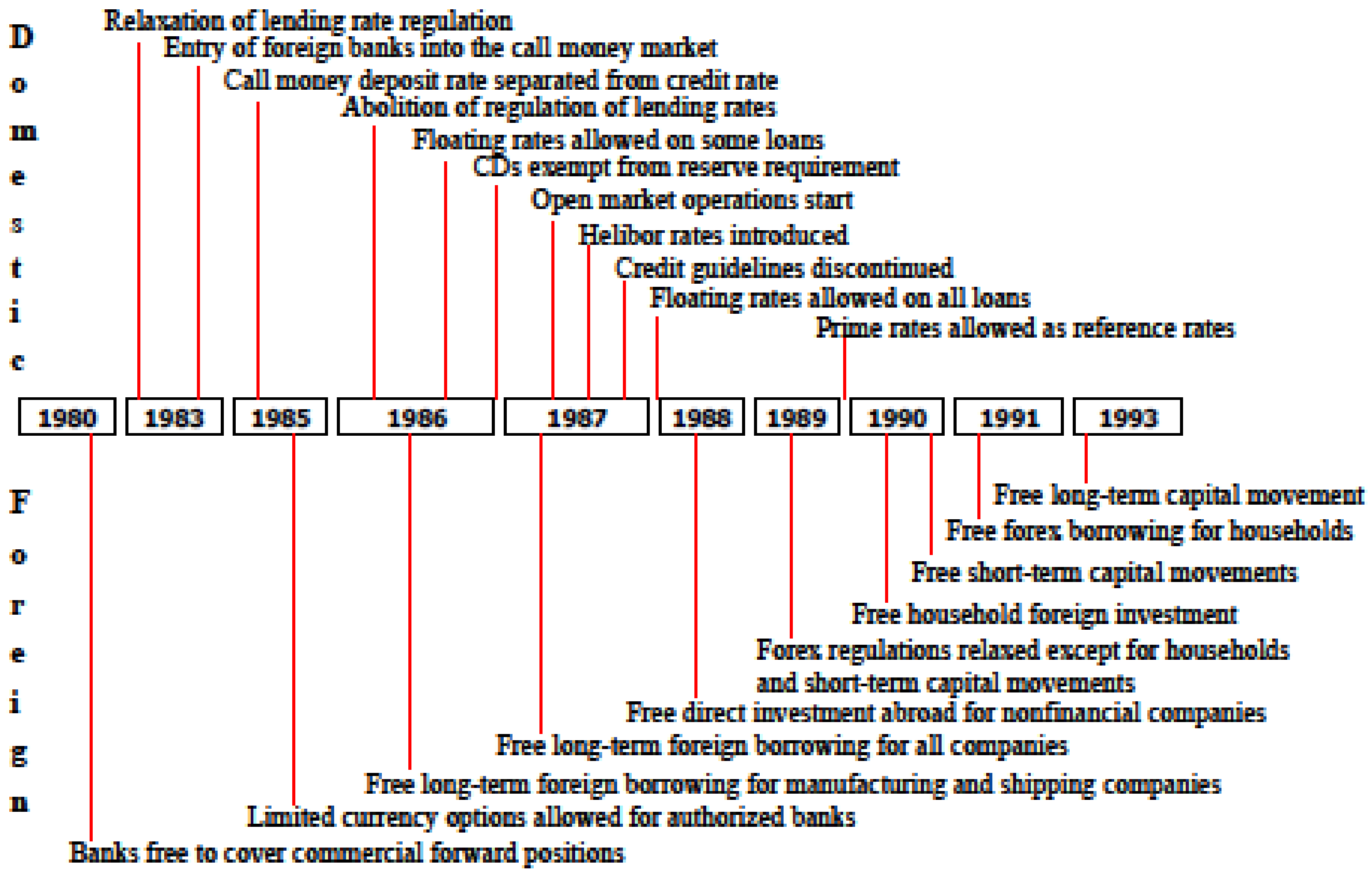


Chart 3B. Deregulation of financial markets in Finland

Source: Englund & Vihriälä (2003)

Lessons?

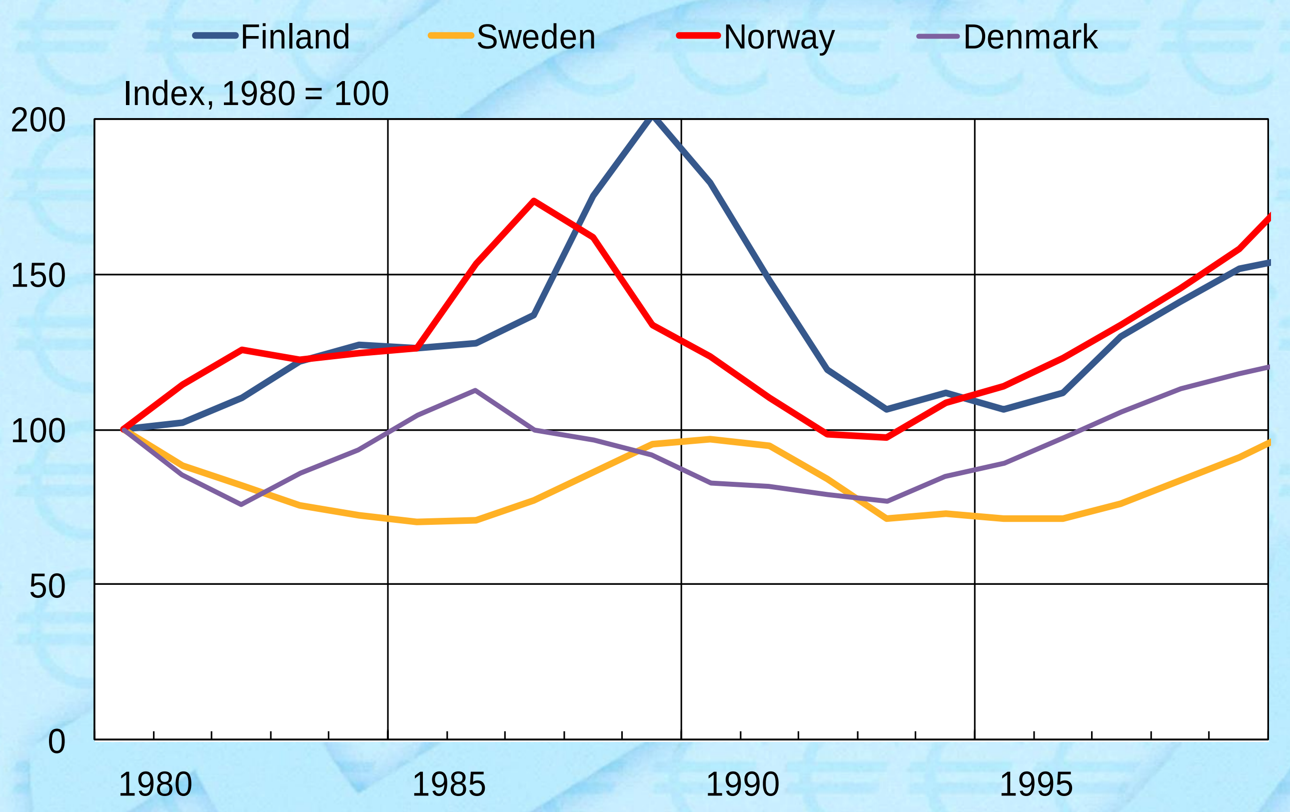
- Liberalization requires a new framework for economic policy:
  - Liberalization financial and forex markets limits the leeway of domestic economic policy.
  - **Impossible trinity:** with free markets one cannot fix exhange rate, domestic interest rate and quantity of finance.
- There are important choices in the order of liberalization:
  - Domestic market before international capital movements or vice versa?
  - Which order for different markets in terms (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 deregul. steps be reversed?
- Finland and Sweden liberalized domestic and currency markets and capital movements in tandem.
  - See preceding figures
- The importance of the taxation system:
  - Is debt finance favored?

Problems in Nordic liberalization

- Bad timing, espec. for Sweden and Finland
  - big steps were taken in 1985-86, when business cycle suddenly turned upward.
  - Collapse of OPEC cartel -> lower oil prices.
    - Recession in Norway.
- A boom developed in Sweden and Finland:
  - Unsatisfied loan demands from households and domestically oriented businesses.
  - Tightening of banking competition, some banks adopted expansionary strategies.
  - Norwegian boom was cut short by the oil price drop.
- At the start of 1990's the boom turned into systemic banking, currency and economic crisis.
  - See figures about asset prices and GDP.
  - Norway experienced only a banking crisis.

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.

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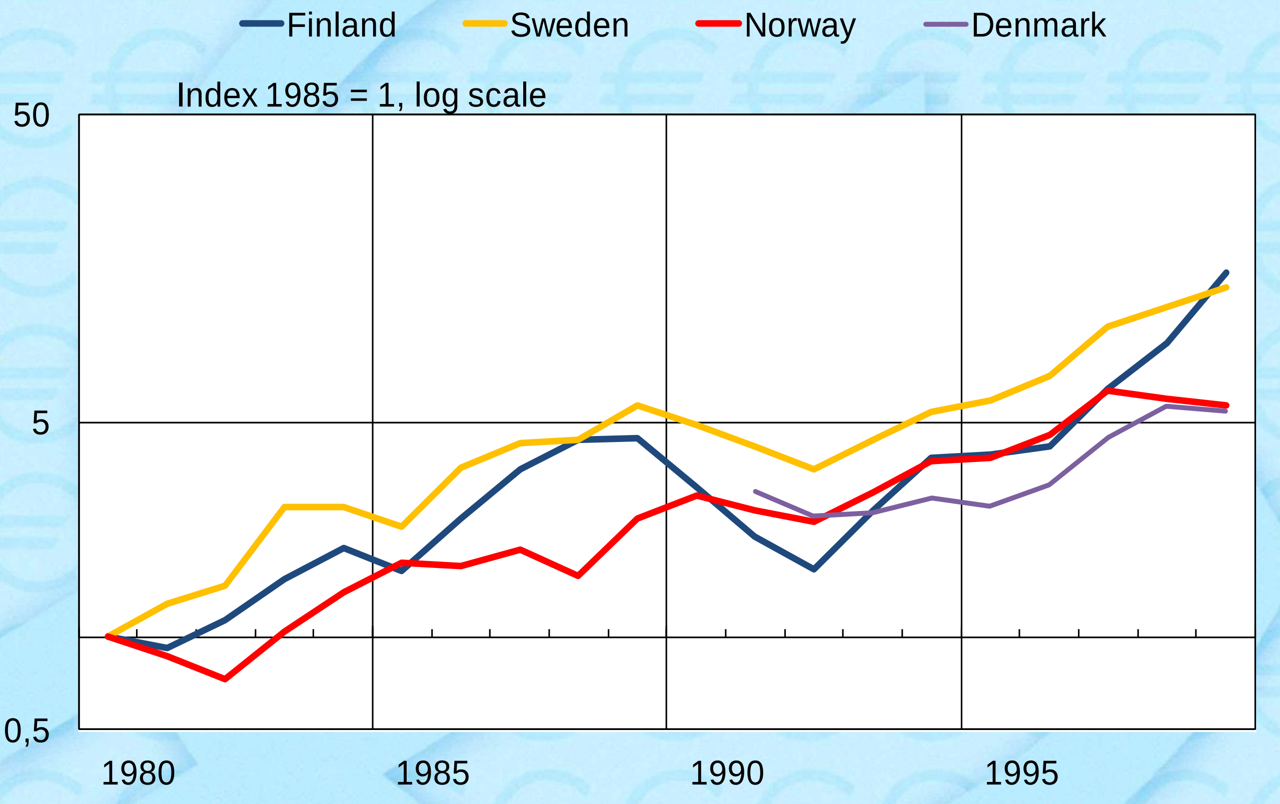
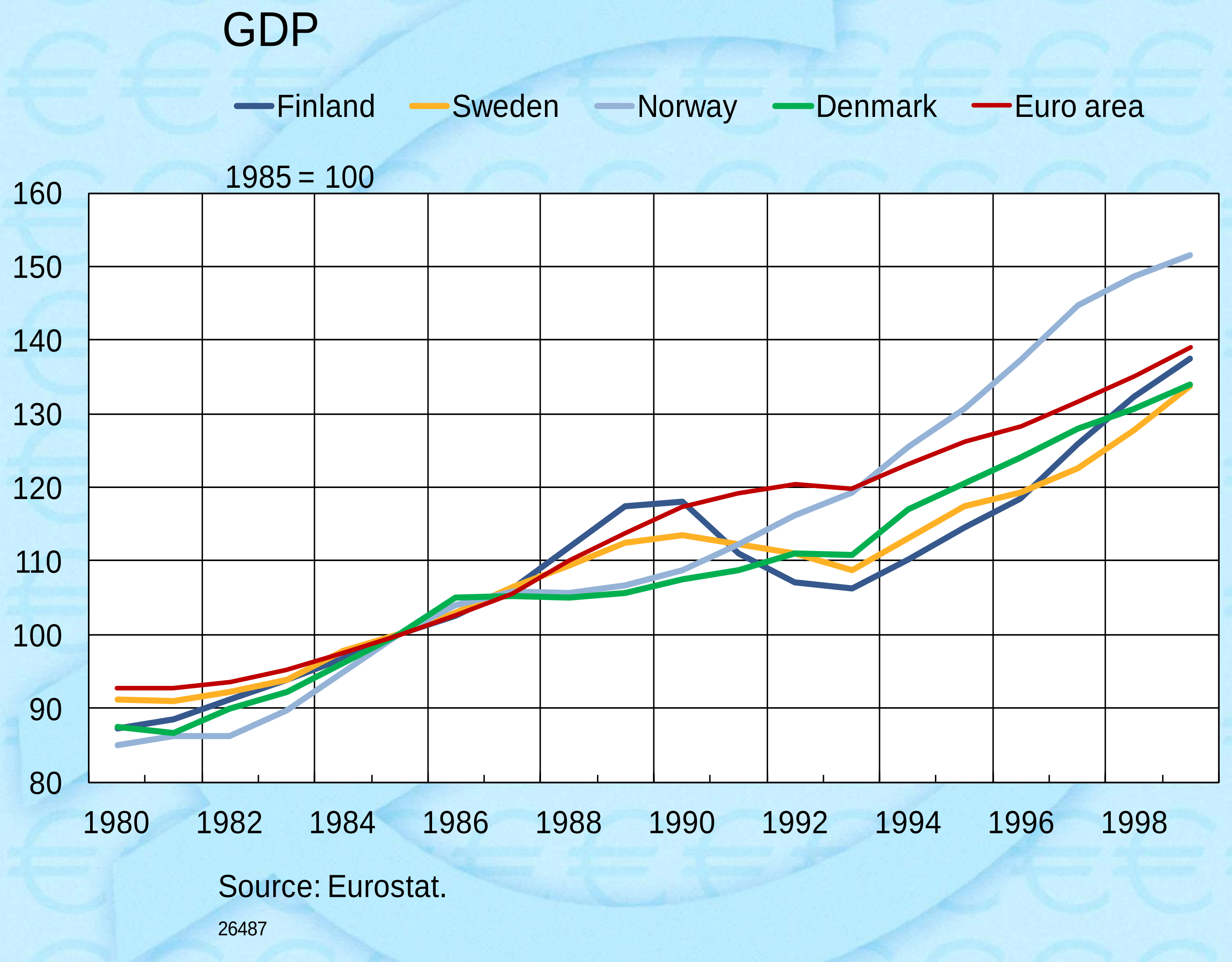
Real share prices



Nominal share prices deflated using the consumer price index.
Sources: IMF, ECB and Bank of Finland.
25125@Chart5 (en)


GDP
Finland
Sweden
Norway
Denmark
Euro area
1985 = 100
160
150
140
130
120
110
100
90
80
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
Source: Eurostat.
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- Denmark had banking problems but no systemic crisis.
  - Most other western European countries avoided a crisis.
- Lessons from the Nordic experiences:
  - Narrow focus on the execution in the acts of liberalization is not sufficient.
  - It is crucial to aid the adjustment of markets, firms, households and banks that must face relatively free price-mediated competition in contrast to the earlier system of rationing.
  - Too little realization that liberalization and price competition imply increased risks.
    - Systemic viewpoint important
- The fixed exchange rate system came under pressure:
  - Floating of FX rates in 1992, adoption of inflation targeting.

Lessons for China?

- **Question: Why look at the Nordic cases?**
  - Some characteristics similar:
    - bank-dominated financial system,
    - credit controls, exchange controls,
    - lack of financial knowledge and risk management
  - Nordic experiences are well documented.
- General lessons:
  - Financial opening need not result in a crisis (Denmark, rest of Europe).
  - Nordic crisis did not lead to political backlash and facilitated moving to an more open economy.

- **Further lessons?**
- Dangers from lack of financial knowledge
- Traditional way of thinking becomes a trap.
- The liberalization reform is much more than just6 technical adjustments.
  - Bankers did not understand well the new system.
  - Academics in universities were also out of touch.
- Important to time well acts of liberalization:
  - avoid pro-cyclicality.
  - Advance changes desirable:
    - Strengthen capital ratios of banks well before.
    - Reform of supervisory system in advance.
    - Reform fiscal policy and the taxation system.
  - Make exchange rate flexible before opening capital movements.

- **Lessons continued:**
- A cautious and gradual approach is probably better than a ’big bang’.
  – International repercussions of the Chinese reform are likely.
  – Good advance preparation can facilitate faster liberalization.
- In case a financial crisis emerges, it is important:
  – Take swift action to maintain stability and confidence of banking system.
  – Contain moral hazard when dealing with banking crisis.
  – Liberalization has long-run benefits for growth and development.
- A fully laissez faire financial system is likely to be unstable.
  - It is important to have an up-to-date regulatory system.
  - The current crisis demonstrates that failures to modernise regulation can be costly.

Thank you!