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The financial crisis in Sweden: The causes, consequences and recovery

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Abstract: The Swedish financial crisis, dealing with financial deregulation and the boom in the late 1980s, the bust and the financial crisis in the early 1990s, the recovery from the crisis and the bank resolution policy adopted during the crisis are reviewed. The paper focuses on: the causes and consequences of the financial crisis, and the applicability of the Swedish model of bank crisis management for countries currently facing financial problems.

Keywords: Financial crisis, financial liberalization, boom, bust, depreciation and recovery - Sweden

INTRODUCTION

The beginning of the 1990s witnessed a severe recession in Western Europe. The climax was the European currency crisis in the autumn of 1992 and summer of 1993. The recession turned most severe in Finland and Sweden, the Northern periphery of the continent. The timing and the nature of the deep crises in the two countries were astonishingly similar – it was the crisis of the twins. To policy-makers and economists the power of the crisis came as a major surprise. The general view had been that such a depression could not happen in advanced welfare states like Finland or Sweden with a long tradition of full employment policies and strong labour union influence on the design of economic and social policies.

The depression brought down the rate of inflation significantly. From the end of the 1980s to the end of the 1990s Finland and Sweden experienced disinflation (Figure 4). During a few months in the 1990s the price level actually fell – inflation turned into deflation. The crisis of the 1990s marks the transition from an accommodative stabilization policy regime characterized by high inflation to a stability-oriented one with low inflation.

The Swedish Economic Environment

By the mid-1980s Sweden had experienced at least a decade of higher inflation rates than many other countries. This resulted in an ongoing real appreciation of the exchange rate, interrupted by occasional devaluations, six times after 1973. The most recent had been in 1982 by as much as 16 %, and had given Sweden a temporarily undervalued currency. But the real appreciation continued, by 8 per cent only between 1982 and 1985. Naturally, this fostered renewed devaluation expectations that were reflected in high interest rates. During the second half of the century the Swedish (1 year) interest rate was consistently 1– 2.5 % above the international average. In periods of currency speculation, as in 1985, the difference rose to as much as 5–6 %. The credibility of the exchange rate was also affected by weak government finances, with the deficit for the consolidated public sector growing to around 7 % of GDP in 1982. The deficit was then gradually brought down and even turned to small surpluses in the boom years 1987–90. But as subsequent developments made clear, it was far from being a balanced budget over a whole business cycle. High inflation interacted with a nominal tax system with full deductibility of interest payments into making real after-tax interest rates low or even negative.

Economic policies prior to financial liberalization fore 1991, when the marginal tax on interest deductions was dependent on personal income. It also disregards variations over time, with a gradual increase in marginal tax rates during the 1970s and a decrease between 1982 and 1985 as a result of a tax reform. We see that the real interest rates were strongly negative all through the 1970s, that they came close to zero after 1980 to become negative again after 1985. It is only in connection with the crisis of the early 1990s that Swedish households met positive costs of borrowed funds for the first time in three decades. World War II unleashed broad-ranging regulations of the Swedish economy. Capital account controls were introduced early during the war and remained in force until 1989. They were complemented in the 1950s by instruments such as liquidity ratios that allowed the Riksbank to set the interest rate and steer credit flows according to political priorities. The external and internal regulations of the financial system facilitated a policy of low interest rates, keeping interest rates below the levels that would have prevailed if there had been no regulatory system in place. The capital account controls were the basis for post-war stabilization policies. They isolated Sweden financially from the rest of the world, in this way allowing for selective monetary and fiscal policies domestically. Commercial banking was turned into an almost risk-free business. Since nominal interest rates were kept low and the tax system allowed large deductions for the cost of borrowing, private sector demand for credit outstripped the available supply. The private sector remained in a permanent state of liquidity rationing. In the early 1970s, the Bretton Woods system broke down. Still, after its demise, capital account controls remained in force in Sweden until the end of the 1980s. In the 1970s, full employment emerged as a major policy goal, one reason being the strong political position of the labor unions. This goal contributed to accommodative fiscal and monetary policies. This policy mix led to low rates of unemployment, high rates of inflation and several devaluations during the period 1976–82. The discretionary exchange rate flexibility allowed the necessary adjustment of real wages required for maintaining full employment and external balance.

The GFC reached Sweden in late 2008. Although prior to the crisis eruption, the export in the country had already started to decline, causing their GDP to decline. The consumers became more cautions with consumption, influencing the financial system with rising funding cost and falling financial asset prices [1].

During the intensification of the crisis in the second half of 2008, Sweden experienced severe economic downturn. The Swedish economy highly depend on export, and was therefore especially hurt by the fall in international trade. The Riksbank reacted by starting to tighten its policies in September 2008. They aggressively started cutting interest rates from 4.75% to 0.25% by the middle of 2009, them reaching their lowest level since the introduction of the inflation target policy [1].

Since July 2010, the Riksbank have been gradually raising their interest rates, but the temporary extraordinary low interest rates was not without risk. The OECD Economic Surveys: Sweden 2011 [1]. page 50 states:

"Extraordinary low interest rates, may lead to a distorted allocation of capital and excessive risk-taking [2]. *Partly because of the extraordinary nature of these measures it can be difficult to asses when to withdraw them. However, it is advisable to do so slowly and gradually, while carefully monitoring financial developments and having policy options available if there is a deterioration in financing availability."*

Sweden abandoned the long-term inflation target of 2% in June 2010, which since the mid-1990 the inflation have been outside the target band about half the time. Although this does not mean Sweden does not have its inflation target under control. They have their long-term inflation expectation anchored and kept it under close control [1].

Sweden GDP Growth Rate

The Swedish economy advanced a seasonally adjusted 0.5 % on the quarter in the three months to March of 2016, following an upwardly revised 1.6 % expansion in the previous period and missing market expectations of 0.7 % growth. It was the lowest reading since the third quarter of 2014, as public spending and investment grew at a slower pace while net exports dragged expansion down. Compared to the first quarter of 2015, the GDP advanced 4.2 %, slowing from an upwardly revised 4.9 % expansion in the previous three-month period. GDP Growth Rate in Sweden averaged 0.56 % from 1981 until 2016, reaching an all time high of 2.50 % in the first quarter of 1984 and a record low of -3.70 % in the fourth quarter of 2008. GDP Growth Rate in Sweden is reported by the Statistics Sweden.

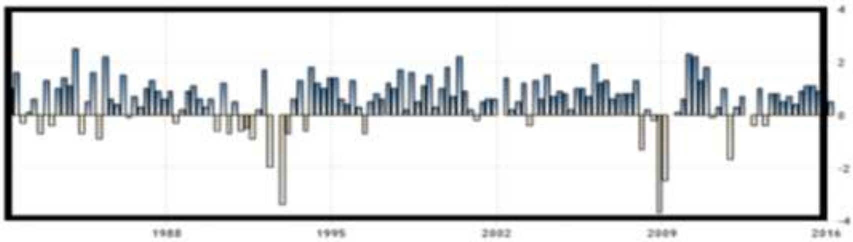

Fig-1: **Sweden: GDP Growth Rate**
Source: Tradingeconomics.com Statistics Sweden

The credit and housing boom in Sweden

The volume of credit to households has grown rapidly since the mid-1990s in Sweden—twice the rate of nominal economic growth. The long-lasting credit boom has been accompanied by rising house prices and mounting household debt ratios. The central bank, the Riksbank, presently pursues a very expansionary policy with negative interest rates and massive purchases of government bonds despite high growth—amongst the highest in Europe.

A new credit cum asset boom 1995-2015

Following the financial crisis of 1992-93, the Swedish economy started on a long recovery. Since the mid-1990s, total credit to GDP has been on an upward trend, almost doubling from 1995 to 2008 (see Figure 1). Household debt to household income has steadily risen for more than 20 years, from 90% in 1995 to 179% in 2015. The Riksbank [3] estimates this ratio will reach 193% by 2018. The Swedish level has far surpassed the peak of 2008 in the US and has now reached the same level of the UK in 2008 (see Figure 2).

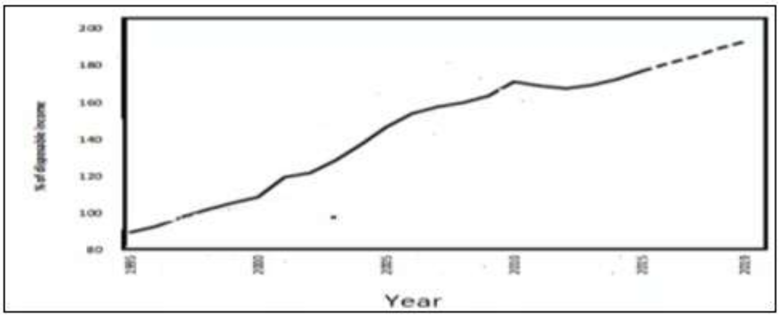

Fig-2: Household debt in relation to disposable income in Sweden, with the Riksbank's forecast for Sweden until 2019

(*Source*: Andersson and Jonung (2015).

The rapid growth in credit is accompanied by a sharp rise in asset prices. Real house prices have grown annually by 4.9% and real stock prices by 6.7%, while economic growth has been 2.5% between 1995 and 2015. The growth in real house prices in Sweden for 1995–2014 surpasses that of the US and the UK by a wide margin (see Figure 3). Contrary to Sweden, these two countries experienced deep financial crises in 2008 which arrested the upturn in house prices. Although Sweden avoided a crisis in 2008, house prices declined slightly in 2008–09, before reverting into a new rise that has tended to accelerate in recent years.

The role of monetary policy

The close association between rising house prices and a rising volume of credit raises the question of causality. Our econometric tests suggest that the expansion of credit has contributed to higher real house prices [3]. The effect is most clearly discernible in the Stockholm region. There is also a feedback from rising house prices, increasing demand for credit. Other factors have impacted on house prices as well, such as restrictions on the supply of housing, rent controls, mortgage interest deductibility, population growth, and a strong rise in household income. But all in all, credit expansion is an important driver behind house price inflation.

The unprecedented growth of credit during the past 20 years is closely associated with an expansionary monetary policy. The Riksbank has reduced its repo-rate from 9% in 1995 to -0.5% in 2015 the expansionary stance is fuelled by Riksbank purchases of government bonds. By now, approximately 30% of all SEK denominated government bonds are held by the Riksbank. This level exceeds the purchasing program pursued by the ECB [3].

The effect of the falling policy rate on real house prices is illustrated by Figure 3. It displays real house prices in Sweden as a whole (black dotted line) and in Stockholm (black solid line) – where prices have increased the most – as well as the policy rate of the Riksbank. The blank areas in Figure 3 correspond to periods when the Riksbank lowered the policy rate compared to the previous year, and the shaded areas correspond to periods when the Riksbank increased the policy rate compared to the previous year. A clear pattern emerges—the growth in house prices stabilises or falls approximately six months after the Riksbank starts to increase the policy rate. House prices begin to rise six months after the Riksbank starts to lower the policy rate.

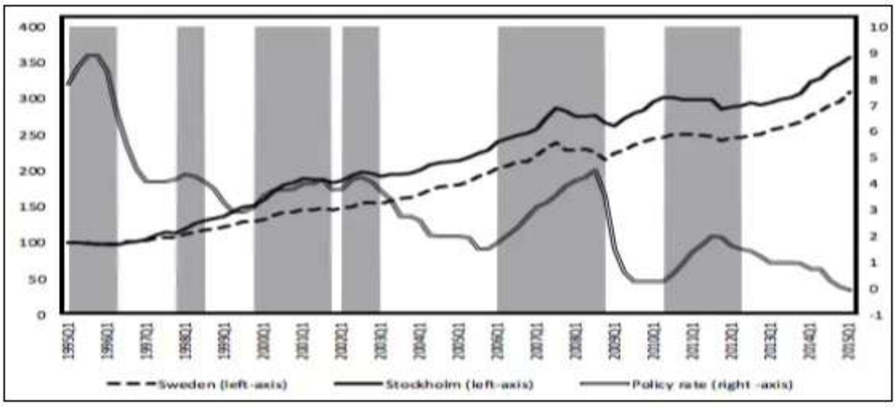

Fig-3: The policy rate (%) of the Riksbank (right-hand axis) and real house prices (index=100 for 1995), (left-hand axis), 1995–2015

Source: Statistics Sweden.

The expansionary Riksbank policy is explained by its adherence to the inflation target of 2%. Low inflation has caused the Riksbank to lower its policy rate despite the stimulating effects on debt and house prices. Since the early 2000s, members of the Riksbank board have been concerned by a possible conflict between financial stability and price stability. In the past five years, tension has been running high within the board. One group has promoted leaning against the wind while another group has argued for the sole focus on the 2% target. Recently, the majority has explicitly moved to the position that the inflation target should be the one and only goal of the Riksbank.

Forecast for the Swedish economy

The Swedish economy is in an upturn. Gradually stronger international growth in increasing the demand for Swedish exports, which in turn is expected to contribute to increased investments, lower unemployment and rising resource utilisation. However, the forecast is uncertain and there is a great risk of weaker growth.

Recovery abroad

A continued recovery abroad creates the conditions for improved economic development in the Swedish economy. The recovery in the euro area appears to be slow, although prospects for economic development have become brighter in 2015. The European Central Bank's expansionary monetary policy has stimulated exports and confidence in the economic outlook has increased among businesses and households. Good growth continues in the United States, where there is a positive trend in the labour market and unemployment has continued to fall this year. In China, a transition is under way from growth driven by investments to growth to a greater extent driven by domestic consumption. This change will probably lead to a more balanced, albeit lower, growth rate compared with 2000–2014. However, the change also presents major challenges, and the recent considerable turbulence on Chinese financial markets could indicate that the transition is proceeding less well than expected.

Relatively high GDP growth in the future

Sweden's GDP is expected to grow at a relatively rapid rate in 2015 and 2016. This is due to several factors, including the expectation that the demand for Swedish exports will accelerate when international growth improves. In the years ahead, consumption and investment growth will also continue to contribute to growth. This applies to household as well as public sector consumption and investments in housing and the service sector. As a result of the recovery in the economy, resource utilization will increase in 2015 and 2016.

The labour market is recovering

The Swedish economy has been in a protracted recession and unemployment has been at a high level for a long time, at around 8 per cent. As the labour force has grown rapidly, employment growth has not been sufficiently high to push down the unemployment rate. As economic activity will improve this year and next year, labour demand is expected to increase, thus also increasing employment. Employment is expected to increase mainly in the local government sector, but is also expected to grow at a good rate in business services and the construction sector. Overall, approximately 250,000 more people are expected to be employed in 2018 compared with 2014. It is estimated that in 2018, the unemployment rate will be close to 6 per cent.

Reduced deficit in public finances

Net lending reported by the general government sector in 2014 came to SEK -75 billion, or -1.9 per cent of GDP*. The deficit is expected to decrease from 2015 onwards. Net lending is estimated to be -0.9 per cent of GDP in 2015 and is expected to be turned into surplus in 2019. The central and local government sectors are estimated to show deficits in

2015, while the old-age pension system is expected to be in balance. General government net lending is expected to increase primarily due to increased net lending in the central government sector. Net lending in the old-age pension system is expected to decrease gradually throughout the forecast period, as a result of the expectation that pension payments will be indexed at a rate higher than the growth of contribution revenues, as well as an increase in the number of pensioners. The local government sector is expected to show weakly negative net lending, while the sector's financial results will be positive during the forecast period. Gross debt as a %age of GDP is expected to decline.

Lessons Learned From Sweden's Experience

Each financial crisis is unique and largely dependent on the specific combination of national and international factors that exist at the time. In addition, the resolution of the crisis is intricately interwoven with a broad set of laws and national characteristics that are unique to each crisis and each national setting. A number of differences between the Swedish and U.S. experiences are readily apparent.

- Unlike the situation in the United States, the Swedish government had a financial stake in the largest banks prior to the crisis. This made the Swedish government a direct stakeholder in the institutions and provided an impetus for it to act.
- Sweden's real estate loans and commercial paper were nearly all domestically held, so that it did not face both a domestic and international financial issue.
- Many nonperforming loans in Sweden were a result of unhedged private sector exchange rate risk when the currency peg collapsed. In the United States, the financial sector problems are linked to the securitization of mortgages, which led to credit exposures that extended well beyond the retail banking sector.
- Sweden's economy is small and open, which enables it to rely on an export-led recovery strategy. The U.S. economy is larger relative to the global economy and it has a strong influence on the pace of global economic growth. As a result, the United States is more likely to rely on a recovery strategy that is based on domestic demand.

Economic forecast

Healthy output growth is set to continue, reaching 3.4% in 2016, with further expansion of employment and gradually declining unemployment. Recent wage settlements will lead to only moderate increases in household income, and private consumption will grow somewhat more slowly than output. Inflationary pressures are projected to remain subdued. Business investment will increase further, and high housing demand will continue to support residential investment.

Buoyant cyclical conditions argue for a broadly neutral fiscal stance, but monetary policy should remain expansionary until inflation is clearly moving towards target. To contain financial risks, an amortisation requirement for new mortgages will enter into force in June and the countercyclical capital buffer will be raised in 2017. Easing planning and rental regulations and phasing out mortgage interest deductibility would help contain the rise in housing demand and household debt, which may prove destabilising if unchecked.

After flatlining since 2006, productivity has picked up lately. Sweden's knowledge-based economy and highly skilled workers make for high productivity, strong integration in the high-value parts of global value chains, and inclusive growth. However, falling school results and comparatively low skills among immigrants pose challenges.

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