I Introduction

The banking industries in several industrial countries, including the Nordic countries, underwent considerable change in the 1980s.[1] It was a period marked by economic deregulation, the removal of cross-border restrictions on capital flows, financial innovation, and increased competition in financial services. At the same time, distinctions between types of financial intermediaries became increasingly blurred. These changes were accompanied in most countries by a sharp credit boom followed by a period of financial fragility, as lower asset quality and interest margins weakened banks' balance sheets. In a number of industrial countries, banks' financial performance deteriorated to the point where governments had to support some of the largest banks to preserve financial stability.

The deterioration of bank balance sheets was particularly marked in the Nordic countries. With the collapse of asset prices and the onset of severe recessions that followed a period of significant domestic overheating, bank loan losses began to mount rapidly in the early 1990s. Given the thin capitalization of banks in these countries, such high loan losses greatly impaired the financial position of the banking system.[2] In Norway, where the crisis emerged first, banks' loan losses climbed from 0.7 percent of total loans in 1987 to 6 percent in 1991. Similarly, in Finland, loan losses rose from 0.5 percent in 1989 to 4.7 percent in 1992. The surge in loan losses was particularly abrupt in Sweden, where they jumped from 0.3 percent in 1989 to 7 percent in 1992. While losses on real estate loans represented a significant share of the overall problem, other sectors also experienced financial distress as the recessions deepened. In Norway, credit exposures to the primary, retail, and service sectors created problems, while in Sweden lending backed by commercial real estate proved problematic, and in Finland the large volume of loans denominated in foreign currency played a special role. Banks also sustained a significant amount of nonperforming loans to households—less so in Sweden—although write-offs have been relatively small in that market segment.

A banking crisis in the aftermath of financial liberalization does not necessarily imply that the crisis was caused by the deregulation. The Nordic financial crises, similar to experiences in other countries, were associated with unfavorable macroeconomic developments, such as economic downturns, declines in incomes, and depressed asset markets.

This study surveys the Nordic banking systems, examining competing hypotheses about the causes of the banking problems and providing some policy lessons. A key conclusion is that factors in addition to business cycle effects explain the financial problems that the Nordic countries have experienced. Although the timing of the deregulation in all three countries coincided with a strongly expansionary macroeconomic momentum, the main causes of the banking crises were the delayed policy responses, the structural characteristics of the financial systems, and—last but not least—banks' inadequate internal risk-management controls.

The Nordic experience demonstrates that if economic incentives are distorted by policy measures and the structure of the financial sector, then a negative shock may threaten the stability of the financial system. The absence of strengthened prudential banking supervision in areas such as real estate and foreign currency lending coupled with expectations of government intervention in the event of a crisis and a booming macroeconomic environment removed incentives for the market to impose discipline on weak banks. At the same time, these conditions prompted many Nordic banks to increase

[1] See Davis (1995) and Llewellyn (1992) for a discussion of financial sector reforms and their consequences in Australia, Norway, Sweden, and the United Kingdom. See Cottarelli, Ferri, and Generale (1995) for the experience of Italy.

[2] Swedish banks had accumulated substantial loan loss reserves, which differentiated them from Norwegian and Finnish banks.

their lending excessively, leading to a loss of efficiency in the allocation of capital. In all three countries, financial liberalization did not lead to an increase in savings as a result of financial deepening. Instead, borrowers responded to the lifting of credit rationing by incurring debt burdens that turned out to be clearly unsustainable. The resulting banking crises can be classified as "growth crises"—fueled by a rush for bank market share—characterized by a delayed response of market forces to weed out inefficient and weak institutions.