

VII Conclusions

Financial deregulation expands lenders' and borrowers' opportunities and capabilities for taking risks. As the Nordic experiences illustrate, if inappropriate incentives coincide with a macroeconomic environment that provides expansionary impulses at the time of deregulation, borrowers and lenders tend to behave in an unsustainable fashion. As a result, the domestic economy can overheat, fueled by rapidly rising asset prices.

Against the background of a quite stable and predictable—yet highly regulated—financial system, the deregulation efforts of the Nordic countries in the mid-1980s were a significant shock to the system. The elimination of direct controls on lending and exchange restrictions triggered a stock-adjustment effect in the debt burden of borrowers whose access to credit had previously been rationed and a surge in lending by banks that gained access to new funding sources. Although these initial stock-adjustment effects were inevitable, certain conditions and policy decisions that prevailed in the three Nordic countries played a critical role in magnifying these initial effects.

For the borrowers, the surge in asset prices during the boom years allowed households and firms to sharply increase their indebtedness without a significant effect on their net wealth. Important factors behind the aggressive borrowing included (1) expectations of rapid economic growth and asset price increases as the deregulation coincided with a strong macroeconomic momentum; (2) the low, and sometimes even negative, costs of borrowing (especially for real estate) owing to tax incentives and a policy of low interest rates combined with persistent high inflationary expectations; and (3) a highly leveraged corporate sector.

The resulting breakdown of traditional banking relationships that followed liberalization weakened banks' ability to assess credit risks and monitor borrowers and made it easier for financial institutions to enter new segments of the credit market. This, in turn, heightened competitive pressures further. In addition, the banking systems were characterized by relatively high operating costs and low profitability

by international standards.⁵² The high operating costs, which resulted primarily from large banking capacity, reinforced the managerial incentives for aggressive lending growth when the vast branch networks threatened to become unsustainable after deregulation. The aggressive bank lending policies were accompanied by a noticeable increase in risk taking. The composition of loan portfolios was shifted toward more cyclical sectors, and loans denominated in foreign currency rose sharply. In all three countries, loans appear to have been underpriced because of competition, and no additional operating profits were being generated to compensate for the greater lending risks, thus increasing the vulnerability of banks to credit losses. Important factors behind the aggressive lending by banks include (1) banks' relatively thin capitalization; (2) the reduced scope for managerial discretion; (3) the slow response of banks to adapt their internal risk-management and credit policies (including complicated cross shareholdings with nonfinancial corporations); and (4) the underestimation of the risks involved in asset-based lending.

It is also evident that policymakers did not take adequate measures to minimize the adjustment costs in the aftermath of the financial deregulation. The authorities failed to tighten prudential bank regulation and to create an adequate supervisory framework to take into account the substantial increase in banks' exposure to real estate lending and lending in foreign currency. The favorable tax treatment of interest payments was not reformed until well after the credit boom. Monetary policy was constrained by the fixed-exchange-rate regime, and the stance of fiscal policy was not tightened in a timely manner and to a sufficient extent.

The Nordic experience confirms that the incentives that accompany deregulation are crucial in transmitting the positive aspects of financial liberalization. In

⁵²With the exception of Scandinaviska Enskilda Banken in Sweden, which was rated one of the most profitable banks in the world.

that connection, it is imperative that banks have a generous equity position and that banking overcapacity that may have built up under the previous regulatory regime is reduced prior to deregulation.

Close attention needs to be paid to the macroeconomic context of financial liberalization. In particular, monetary conditions have to be monitored carefully following liberalization to prevent the initial jump in asset prices from developing into a speculative bubble. In light of these macroeconomic uncertainties, it is essential that, parallel to deregulation, banks strengthen their internal management

controls and especially their risk management. These efforts should, in addition, be supported and enforced by an adequate supervisory framework.

If banks do not take these steps and if the liberalization process is not designed carefully, problems will emerge. The competitive pressures that are typically enhanced by liberalization and the distortions in the incentive scheme caused by policy measures and the inherent structure of the financial sector will magnify the impact of a negative shock to the system and will threaten the stability of the entire financial system.