

# Finnish banking crisis of 1990s

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## **1. Introduction**

Finland experienced a severe financial crisis in the early 1990s. There were both international and domestic factors contributing to the crises and some of them emerged long before the actual crisis. In this paper I will first give description of the background and evolution of the main events of the crisis. After this, I will point out the main reasons for the crises and explain why they were important. This paper is based on Seppo Honkapohja's discussion paper *The 1990's financial crises in Nordic countries* but it also largely owes to a working paper by Peter Englund and Vesa Vihriälä *Financial crises in developed economies: The cases of Sweden and Finland*.

## **2. The economic situation and financial systems of Finland in 1980s**

Finland's economic growth in the 1980s was somewhat faster than in most Western economies. The growth of production averaged 3.7% during the 1980s and reached a high of 5.7% in 1989. The export to Soviet Union accounted for the biggest part of the Finnish exports. The trade with the Soviet Union was substantial, nearly one fifth of total and that way very important to Finland.

In the 1980's Finnish financial system was still comparatively undeveloped and much smaller than what was typical in Continental Europe. Stock market was poorly developed and played a modest role in financing new investment. This was due to a tax system that favoured financing through retained earnings. Consequently, stock market capitalization ratio was below 10 percents of GDP in the first half of the 1980's. However, later when the stock market reached its top in 1989 the capitalization rate had doubled.

The number of banks in Finland was significantly large, 632 in 1985. There were savings banks and co-operative banks. Savings banks owned a commercial bank called Skopbank. Skopbank acted as central bank for individual savings banks providing liquidity and various specialised services to the savings banks. In addition, it had access to central bank and foreign financing. Co-operative banks, instead, owned jointly Okobank. Consequently, however the savings banks

as well as co-operative banks were formally independent entities they can be considered as two bank groups covering the whole country.

In addition to the two bank groups there were two commercial banks Kansallis-Osake-Pankki (KOP) and Suomen Yhdyspankki (SYP), and the Post-office bank (PSP). The commercial banks and PSP offered lending and other services to large corporations. Savings banks provided housing and real estate lending and co-operative banks focused on agricultural and small enterprise lending.

Bank profitability was relatively poor in Finland. When the interest rates were highly regulated the price competition wasn't really effective. Local banks were practically oligopolistic with small number of banks offering almost identical services. Savings banks were weakest in profitability. They were inefficient generally due to the small size and poor changes to get position in profitable corporate lending.

The activities of the banks were tightly regulated by various types of conduct rules. Banks' pricing policies were regulated by ceilings set by the central bank on each institution's average lending rate and top rates. All banks were also required to offer the same interest rate linked to the central banks base rate. Consequently, the banks competed mainly by service provisions, quality and availability of services.

Regulated interest rates were low relative to inflation. However, people were willing to keep deposits in banks because basically other alternatives weren't available; stock and bond markets were small and illiquid and investments abroad were prohibited or required a special permission.

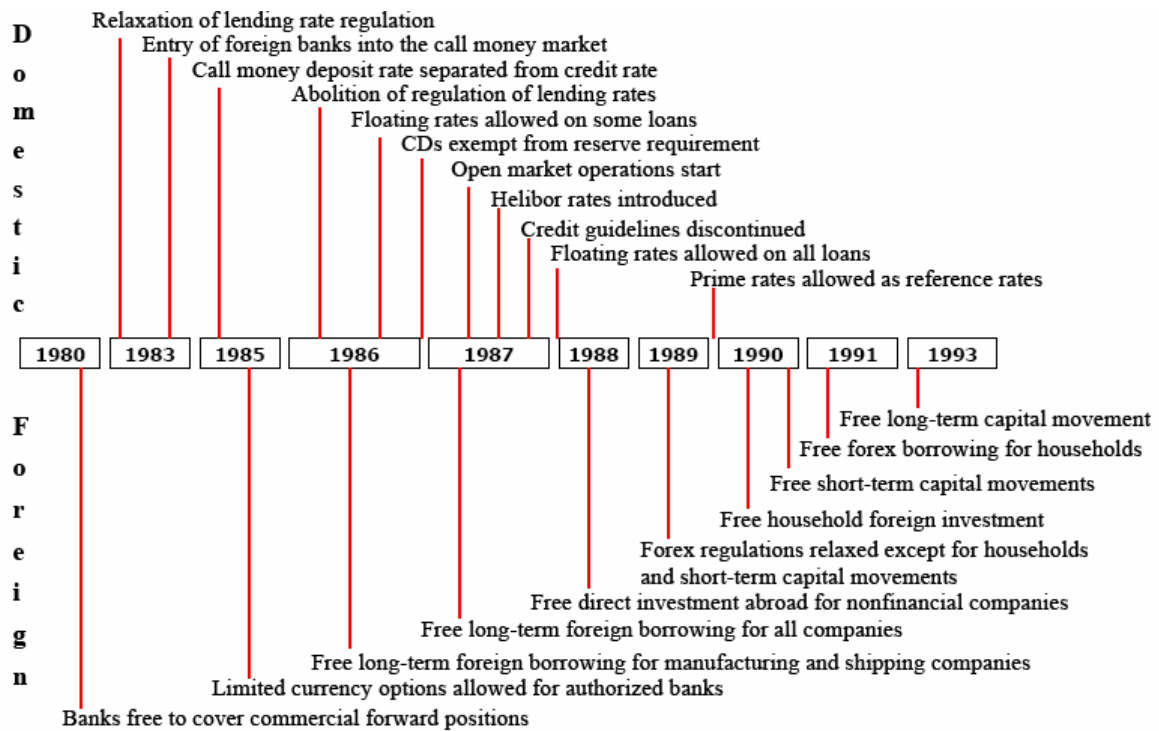
### **3. Liberalisation of the financial system**

The deregulation process started in the early 1980's but the main changes took place in the second half of the decade. Under regulation, obtaining a loan from bank had been a sort of privilege. The reason for deregulation was that regulations were often circumvented and this

increased the dissatisfaction among those households and firms who wanted to play fairly or couldn't circumvent the rules. In addition, technological development and internationalisation made for example corporations less dependent on the inefficient domestic market.

The deregulation took place gradually but wasn't carried out in a most logical way. After several liberalisation measures, in 1986 restrictions on lending rates were fully abandoned. After two years, the central bank credit guidelines were abolished and the remaining restrictions on the use of floating interest rates in loan contracts were removed. Before deregulations the savings banks and co-operative banks weren't allowed to grant credit without secure collateral. Consequently, deregulations created intense competition between banks and gave them an opportunity to expand. At the same time this led to increased risk taking without understanding the risk fully. The banks were actually improving their profitability artificially by growing uncontrollably. The increased profitability was basically an illusion because it didn't account the credit risks of the new loans.

International capital movements were freed during 1987 and 1988. This led to enormous increase in capital inflows, largely in foreign currencies which were not hedged. For banks this meant improved access to foreign sources funds and reduced their dependence on central bank funding. Moreover, due to restrictive monetary policy, the interest rate differentials between domestic and foreign rates fortified the inflows further. As long as there was no devaluation in sight substantial gains were achieved by borrowing in foreign currencies and investing in markka. In addition, the falling energy prices and rising price of forest products caused significant increase in Finnish trade and this fuelled the overheating further.



Source Peter Englund - Vesa Vihriälä. 2003

#### 4. Consequences of the deregulation

Because lending was now easy it created more demand for real estate and stock. This pushed asset prices rapidly upwards. Consequently, even though household indebtedness increased substantially, it was matched with the parallel increase in asset values. Since the banks assumed the high assets prices to be sustainable, the household borrowing didn't appear excessive to them. However, now it is easy to say that the rise in asset prices was a bubble since the rise couldn't be explained by fundamental factors.

During the second half of the 1980's household debt as a fraction of disposable income as well as corporate debt to nominal GDP, increased both by 20 percents to 80 percents by the peak of the boom. Particularly, large fraction of the corporate debt was in foreign currency, even among firms with no foreign-currency revenues that would have required hedging. The high inflation combined with interest payment being tax-deductible made borrowing very attractive.

Financial supervision was split between more than one government agency and the resources devoted to them were modest. Thus, the supervision wasn't working in financial markets. In addition, macroeconomic policies like tax cuts were supporting growth rather than restraining it.

## **5. The crisis emerging**

Early signs of overheating and distress emerged in 1989. However, the fixed exchange rate regime made it difficult for central bank to rein in the overheating. The Skopbank was put under special surveillance by the Bank of Finland and the Bank Inspectorate.

The end of boom was to be seen in 1990. The economic activity declined as a result of weakening international economic activity due to the crisis in Persian Gulf and rising foreign interest rates. The rising foreign rates emerged about depreciation of the currencies and drove the domestic interest rates up. The asset prices were falling. Also private investment started to fall and consumption stagnated. When the demand fell and interest rates rose, some firms started to have problems in servicing their debt burden. The collapse of Soviet Union dropped the exports significantly and deepened the crisis.

In 1991 Skopbank couldn't even obtain overnight funding and the Bank of Finland took over it. In addition to increasing unemployment and number of bankruptcies as well as declining economic activity, the failure of Skopbank increased pessimism about the state of the economy. Devaluation speculation was heating up. Finally, the devaluation of 13 percent took place at the end of 1991.

Large fraction of bank loans turned to non-performing. In 1992 three banks had to be taken over by the state and the remaining banks became dependent on government support. The peg was abandoned and markka started to float. A special institution called Government Guarantee Fund (GGF) was created and it was to become the central body of bank support operations. The costs to the public sector were substantial. Paid-out support amounted 13,9 percent of the annual GDP of 1991.

The end result was that all failed banks ceased to exist. As earlier mentioned, the cost-inefficiency of the banks was significant already before the crisis. That's why strong rationalisation was needed to build a sound basis for the banking system. The number of employees as well as the number branch offices declined by more than 50 percents in 1990s. Consequently, at the end of 1990s Finnish banking sectors employed the least personnel relative to population in the whole EU. In addition, Finland has been a pioneer in introducing modern banking technologies.

## **6. Reasons for the crisis**

### **6.1. Deregulating not a sufficient condition**

It is often claimed that the key reason to the crisis was the deregulation of financial markets in 1980s. However, such reforms have been undertaken all over the world without every country deregulating ending up in a financial crisis. What really mattered was the real, exceptional large credit expansion following the deregulating. Actually there is econometric evidence of strong correlation between the credit growth and the probability of banking crisis. However, there have been several countries facing financial liberalisation followed by a lending boom without crisis.

The key reason was neither deregulation nor credit boom followed by it, but the credit boom with expansive macro policies and these two together impacted the aggregate demand. This combination together with absence of effective supervision and other institutional arrangements was leading banks to excessive risk taking. Excessive risk taking can partly be explained by a lack of understanding among bankers. The bankers of 1980s had little experience on operating in unregulated markets and even less on handling large credit losses later. To sum up, the deregulation was right thing to do but Finland was ill prepared for it.

## **6.2. External macro shocks played a significant role**

Finland as a small open economy is, and was that time, extremely sensitive to external shocks. There were, unfortunately, many negative international macro shocks during the years around 1990. Firstly, the increase in European interest rates after the reunification of Germany. Secondly, the declining demand in OECD area due to the crisis in Persian Gulf and rising interest rates. Finally, the collapse of the Soviet Union and the plunge in Soviet export market which was particularly important to Finland.

## **6.3. Fiscal policy was unsuccessful**

During the years of overheating taxes were cut. However, reducing tax expenditures like the interest expenses in household taxation were attempted but met, of course, a strong resistance. Politically, the situation was challenging. When the booming economy was accumulating large surpluses tightening the belt was difficult to explain. The problem is still here, no politician is willing to raise taxes. Usually it means automatically losing the next elections. However, when the crisis hit, government finances declined rapidly and expenses were radically cut. This reduced, at least as a direct effect, aggregate demand and deepened the recession. Shortly, right movements were made but timing was totally wrong.

## **6.4. Fixed but adjustable exchange rate wasn't sustainable**

All previous financial crises have taken place in countries with fixed exchange rates. There is a consensus that a fixed but adjustable exchange rate is a conducive factor to financial crises.

Since the authorities and a large majority of the academic opinion averred that there wasn't devaluation in sight, the market confidence in the existing parities remained strong despite the large interest differentials. This made the monetary policy ineffective. Moreover, many companies were taking huge risks by taking debt in foreign currency without hedging, to benefit from the differential they assumed to sustain. However, the fixed exchange rate had to

be abandoned at the end. It is very likely that Finland would have benefited from earlier abandoning by avoiding further speculations on devaluation after the devaluation in 1991.

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