Effective Practices in Crisis Resolution and the Case of Sweden

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The current financial crisis is a painful reminder that the developed world is not yet immune to these devastating shocks. But while we haven’t learned to prevent them, we have learned some lessons about what is necessary to contain them once they begin and to limit the damage that follows. As policymakers worldwide focus on resolving the current financial crisis, they might look to Sweden as a useful model for effective strategies.

Decades of institutional development in the global financial system have not removed the specter of financial crisis from the landscape. The current worldwide credit crisis was preceded in the past 15 years by debt and currency crises in Latin America and East Asia, not to mention the collapse of Long Term Capital Management, a large hedge fund in the United States. However, the most severe events have generally occurred outside of the developed world, where regulatory frameworks, financial policy, and industrial maturity were thought to have ended an era of large macroeconomic fluctuations.

Yet the current credit-market tumult reminds us that the developed world is still acutely susceptible to financial crises. While governments and regulators haven’t managed to prevent these crises, they have learned some valuable lessons about what is necessary to contain them and limit the economic damage that follows. Financial crises often spring from imbalances in the economy, such as an overexposure to risk brought on by booming asset markets. Researchers have identified a number of practices that seem successful at stopping the financial bleeding brought on by a crisis while also preventing similar excesses from reemerging in the future.

In this Commentary, we describe these crisis resolution practices and discuss the way in which Sweden applied them in the early 1990s. The Swedish banking crisis is a useful example for two reasons. First, at the onset of the crisis, the country had a modern banking system similar to those found in other advanced economies. At the same time, Sweden’s disciplined management of the crisis—which followed the bursting of a credit bubble—appears to have minimized the impairment to its future economic prospects.

Resolving Financial Crises

We maintain that the goal of any resolution strategy should be to transfer assets from failed financial institutions to institutions that can put the assets to their most efficient use, and at the least possible short and long-term costs to the taxpayer. As in most things, this is easier said than done. When faced with financial markets and institutions that appear to be spiraling out of control, regulators and policymakers often resort to blanket guarantees of uninsured deposits and other liabilities by providing unlimited liquidity to financial markets until the crisis dissipates.

While blanket guarantees might be policymakers’ best choice given the urgency of bringing some calm to markets, history shows that such guarantees have their dangers: They bail out investors who should have done a better job at evaluating and managing their risks and disciplining financial institutions that were mismanaging their money. It is worth emphasizing this point, as the smooth operation of our financial system depends on market discipline. In normal (stable) financial environments, investors protect their investments by actively monitoring people who manage their money. By refusing to provide funding, they can raise borrowing costs for firms and force ineffective or imprudent management to change. Limiting losses for investors during a crisis causes them to anticipate bailouts in the future, which erodes their incentive to do such monitoring during the good times. Likewise, pledges by policymakers to extend unlimited liquidity to troubled institutions open the door for investors to exit their investments without incurring losses in their entirety, potentially leaving taxpayers to take the hit further down the line.

Nevertheless, it is possible for regulators to clean up systemic messes without inviting new ones. In a recent paper, economists Emre Ergungor and James Thomson analyze the research done to date on the impact of different approaches taken to resolve financial crises across the globe. They identified a handful of practices common to successful financial crisis resolutions.

Most important, according to Ergungor and Thomson, is that successful crisis resolutions have been characterized by transparency. When officials move to contain a financial crisis, their primary task is to identify which institutions are viable and which assets are good, and conversely which institutions are insolvent and which assets are bad. This triage and full
growth stagnating in the 1980s, Swedish policymakers gave a

boost to economic growth by loosening lending restrictions on
banks and devaluing the country’s currency, the krona, which
was kept at a fixed exchange rate. Domestic banks used their
new-found power to pump credit into a system with pent-up
demand. Foreign investors were happy to channel their money
to this underserved credit market. The economy boomed on
funds borrowed in foreign currencies.

The reckoning came in 1990, when Germany was reunified
and its deficits soared. The Swedish krona, which was strongly
tied to the German mark, automatically imported Germany’s
high interest rates to Sweden. This started to squelch demand
for real estate, and when the Swedish government eliminated
its consumer debt subsidy, demand in this market all but dis-
appeared. Real estate prices that had more than doubled in the
1980s now fell more than 40 percent (see figure 1). Then in
1992, the krona plummeted in value after it was taken off the
fixed exchange rate. Banks, businesses, and individuals that
had borrowed in foreign currencies—but whose incomes were
in kronas—found themselves unable to meet their obligations.
Domestic nonperforming loans hit 11 percent of GDP in 1993.

With conditions so dire, and with Swedish banks so heavily
exposed to the real estate market, the banking system began to
disintegrate. In 1991, two of Sweden’s largest banks, Fören-
ingsbanken and Nordbanken, fell below their required capital
levels. Afraid of a meltdown, the government guaranteed all of
Nordbanken’s liabilities and took ownership of the bank, while
at the same time arranging a guarantee for Föreningsbanken.
Domestic nonperforming loans hit 11 percent of the
nation’s banking assets. Policymakers acted quickly to separate
the good from the bad. Government-held assets that were
deemed viable were merged under one name, Nordbanken,
and permitted to continue operating. Bad assets were trans-
ferred to two asset management companies (AMCs)—Securum
for Nordbanken’s assets and Retrieva for Gota’s.

A third practice associated with a successful resolution strategy
is the maintenance of market discipline. Without it, note
Ergungor and Thomson, the stage is set for future crises. If
market discipline is to be effective, investors who assumed
greater risks must be credibly exposed to loss; that is, they
must suffer the consequences of having ignored or failed to
detect signs of trouble. Blanket guarantees of uninsured depos-
itors and investors are an example of a policy maneuver that
might lessen the pain of a crisis but could also distort market
discipline. As numerous historical examples demonstrate, the
stability of financial markets after crises largely depends on the
incentive framework that is left in place.

Figure 1: Housing Price-Rent Ratio in Sweden

The Swedish Financial Crisis
The early 1990s crisis in Sweden followed a massive credit
bubble largely characterized by speculative real estate ventures
and booming consumer debt. With inflation creeping up and
growth stagnating in the 1980s, Swedish policymakers gave a
disclosure of associated losses clears the uncertainty surround-
ing the financial institutions and makes it possible for the
viable institutions to raise new funds from private investors
or from the government if private sources are not available.
Failing to acknowledge the true value of assets or the condi-
tion of troubled banks early on makes it easy for them to live
on as propped up “zombies” (as happened in Japan during the
1990s)—healthy on paper but economically insolvent. Initial
full disclosure avoids these situations, and improves efficiency
during industry restructuring.

Second, crisis resolutions have been most successful when
they were handled by a politically and financially independ-
dent agency. Granting independence to those responsible for
containing the crisis and restructuring shields decision makers
from political pressures, which mount as institutions are closed
and assets are liquidated. The decision to close a financial
institution or a business must be an economic, not a political,
one. Financial independence is necessary to give credibility
to political independence: If a government agency holds the
purse strings, it can dictate policy. Independence from chang-
ing political environments is also important because it allows
for a rapid response to emergent funding needs (as when new
losses are discovered in a financial institution). Having to wait
for the legislature to appropriate funds in these situations can
be impractical.

Finally, Ergungor and Thomson observe that containing
troubled financial assets and restructuring institutions has
typically not been enough to resolve a financial crisis entirely,
though doing so positions the system to return to more nor-
mal functioning. They find that full crisis resolution must also
achieve some restoration of credit flows within the economy.
For that to happen, the creditworthiness of borrowers must be
restored throughout the economy—a difficult task, given that
the economic fallout from a crisis (such as rising unemploy-
ment) actually erodes credit quality further.

The case of Sweden—one of the relatively successful crisis res-
olutions of the past 30 years—provides good insight into most of
these practices.

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The AMCs were charged not only with managing and liquidating the bad assets of these banks, but also with taking on the assets of nonbank companies that were in default. Swedish legislators made sure that the AMCs were adequately capitalized and granted exemptions from regulatory rules that would have rushed their actions or limited their effectiveness, including an existing rule that required seized collateral to be liquidated within three years.

Often, the AMCs became managers of otherwise private, failed companies, performing such tasks as hiring and firing, managing property, and changing operation strategies until their assets could be favorably sold. Their tremendous flexibility and financial resources shortened their own existence from an expected duration of 15 years to a few years. Liquidations were completed in 1997, and what funds the AMCs had remaining (less than half of their original capitalization, in real dollars) were returned to the Swedish treasury.

**Is Sweden a Useful Model for Crisis Resolution?**

On the surface, it would appear that Sweden’s resolution of the crisis was a success. The nation returned the assets of failed banks and corporations to more productive uses via asset sales, and avoided the economic carnage that could have followed a complete systemic meltdown in the financial sector. However, the global economic boom that marked most of the 1990s makes it difficult to disentangle keen Swedish policy choices from macroeconomic “luck” when examining the resolution’s outcome.

An IMF study by economists Valerie Cerra and Sweta Saxena further questions the extent of Sweden’s success in limiting the aftermath of the crisis. They found that the long-term trend of Swedish per capita GDP growth fell from at or above similar countries’ levels to a much lower level in a time interval that coincides with the financial crisis. The trend has remained at these relative levels since, reminding us that temporary damage to the financial sector may have longer-lasting detrimental effects on the real economy. That some amount of macroeconomic damage will follow a crisis is not surprising, given the financial and, sometimes, structural rebalancing that a systemic panic necessitates.

Even at slower growth levels, Sweden emerged from its credit market turmoil without the zombie banks and nonexistent growth of Japan’s “lost decade” in tow. This achievement has to do at least partly with Sweden’s containment and resolution strategies. With regard to transparency, Sweden performed remarkably well. The magnitude of losses was established early on by a Bank Support Authority, which was independent from the Ministry of Finance and the central bank. Good assets were separated from bad assets, and the full extent to which government would be involved was clearly outlined. Initial transparency about losses at the outset likely avoided the “zombie” effect and what Douglas Diamond has called “evergreening,” a process whereby undercapitalized banks choose not to address problem loans because doing so would force asset write-downs, possibly prompting technical insolvency. The Swedish government’s swift moves to liquidate failed banks and its emphatic pledge to recapitalize viable ones avoided large-scale evergreening, the papering-over of losses, and the prolonged stagnation that lingering bad assets entail.

Sweden’s response to the crisis also extended considerable political and financial independence to the AMCs, which allowed them to carry out their task with adequate resources. It also served as a public signal that their operations would not be subject to changing political winds. Similarly, Swedish officials’ relaxation of collateral liquidation requirements implied that the dispensation of assets would take place over an extended period of time. This regulatory change may have had conflicting effects on investor perceptions. On one hand, it signaled that a large overhang of assets would not flood the market early on and drive down the value of similar, privately held assets. However, early liquidation, even at what appears to be distressed price levels, can quickly return assets to more productive uses and lower the cost to taxpayers if asset values continue to slide. Though this is a difficult balance to strike, Sweden’s AMC managers were at least given the option to liquidate at later times if they deemed it necessary.

With respect to the restoration of credit flows, Sweden moved quickly to provide incentives to bank owners to inject additional capital into their banks or to inject government capital into banks directly, when necessary. AMCs played a key role in restoring the financial health of the nonbank companies they were operating. Some viable corporations were allowed to survive through capital injections, though in return the government acquired a majority of their shares so that taxpayers could profit from any upside. Recapitalized institutions could return to ordinary operation, gradually rebuilding the creditworthiness of the overall economy. Credit restoration has proved to be among the most difficult resolution steps to execute effectively, and it can involve different public–private hybrid models to enhance the probability of success. An alternative to the Swedish method that is both bank and borrower-based was attempted by Mexico in the late 1990s, with a program called Punto Final. The program subsidized 60 percent of a loan if the borrower started repaying it, a cost that was shared equally by the government and the lender. The government’s share of the cost would also increase in proportion to the number of new loans the lender made. This had the effect of subsidizing only good loans (failed borrowers would rather default than keep throwing money at a loan they could not repay) and incentivized lenders to start credit flowing again.

Sweden’s success at maintaining market discipline was perhaps more limited. Ideally, discipline can be sustained by not taking actions that may weaken investors’ incentive to discipline, such as issuing blanket guarantees and unlimited liquidity. In the Swedish case, policymakers avoided the liquidity pitfall but still ended up guaranteeing bank liabilities before the banks themselves were taken over. Investor disincentives to closely monitor financial institutions in the future may still exist as a result. The economists Edward Kane and Daniela Klingebiel have suggested an alternative to such incentive-skewing guarantees. They have argued that the optimal response to a systemic banking crisis is to call a bank holiday long enough for examiners to determine which
banks are viable, while still giving insured depositors access to their funds. Doing so would insure business as usual for insured depositors without permitting uninsured depositors to cash out before taking their share of unrecoverable losses.

Most of the criticisms that can be leveled at the Swedish crisis resolution are easy to make in hindsight. Facing the prospect of imminent systemic collapse, incentive-skewing actions like blanket guarantees and liquidity provision can seem like surefire ways to restore confidence and avoid meltdown.

Sweden’s financial crisis containment and resolution strategy largely avoided these mistakes. Policies were enacted transparently and with political independence, and attempts were made to restore credit flows in the broader economy. Although some research has shown that a per capita growth penalty has been exacted from Sweden, its postcrisis decisions avoided the preventable pain of holding toxic assets for too long.

Altogether, the Swedish case illustrates the trade-offs and considerations of market discipline that crisis managers must contend with if they are to minimize taxpayer losses and speed the return to a rebalanced, growing economy.

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