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FINANCE AND THE WELFARE STATE

Banking Development
and Regulatory Principles
in Sweden, 1900–2015

Mats Larsson
Gabriel Söderberg



Palgrave Studies in the History of Finance

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Mats Larsson · Gabriel Söderberg

Finance and the Welfare State

Banking Development and Regulatory
Principles in Sweden, 1900–2015

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Preface and Acknowledgements

The development of Swedish banking over the past century has been turbulent, marked by fast expansion, conflicts between ideologies and economic interests, and financial crises. In this book, we focus on the relationship between the state and market actors, which has been of fundamental importance for the transformation of the financial system.

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Introduction

Abstract In the introductory chapter, Sweden's financial system is presented as an example of the interaction between politics and banking. Sweden implemented banking regulations after World War II, which initiated a new regulatory regime, and opened for a strong political guidance of the financial sector. This chapter discusses the establishment of different financial regulatory regimes from an international perspective, as well as the nature and rationality of regulations in the banking sector.

Keywords Sweden · Banking regulation · Macroeconomic regime

In the wake of the financial crisis of 2007–2008, there is substantial uncertainty about the future of the international economy. Low growth rates, low inflation, and high unemployment in developed countries have led to large government debts, zero or even negative interest rates, and radical monetary actions in the form of quantitative easing (QE).¹ The crisis called into question the authority of the theoretical orthodoxy that financial markets are stable and efficient and that regulations are

inherently harmful to the economy. This doubt, together with the fact that the crisis originated in the banking sector, has led to a renewed sense of urgency regarding the issue of bank regulation. On the international level, the Basel III regulations have been hammered out in countless rounds of negotiations. At the time of this writing, addendums to the Basel III regulations are still being negotiated, but they will likely be completed by the end of 2017.

There are concerns, however, that these new regulations are inadequate to prevent another crisis. For example, the *Financial Times*' Martin Wolf quipped that Basel had "labored mightily and brought forth a mouse."² Similar concerns have been voiced by scholars such as Anat Admati and Martin Hellwig, most notably in their book *The Bankers' New Clothes*.³ Conversely, others argue that the new regulations threaten to suffocate the financial market, making it even less functional and potentially obstructing general economic growth.⁴

Although new regulations have been issued, the history of banking in the twentieth century suggests that the problem is more complicated. Banking, like the economy in general, is a historically evolving activity. As soon as regulations are in place, banks start to find ways to circumvent them and in the process create new forms of organizations and securities.⁵ The epithet "shadow banking" has been coined to capture this phenomenon. A new macroeconomic regime and the banking regulations it adopts might thus already be sowing the seeds of its own dissolution. Edward Kane called this "regulatory dialectics," noting that "bureaucratic controls and market adaptation chase each other round and round, generating additional problems, confrontations, and costs for society at large."⁶

Similar skepticism was inherent in the work of Hyman Minsky. Minsky's theories have experienced a renaissance after the crisis. The *Wall Street Journal* in 2007 even dubbed the outbreak of the crisis a "Minsky Moment."⁷ According to Minsky, the evolution of the banking sector was a fundamental aspect of the financial economy. In his most elaborate work, *Stabilizing an Unstable Economy*, he wrote, "Profits made by bankers increase as bankers discover ways of increasing the return on their assets or decreasing the cost of their liabilities. To do this, banks innovate by introducing new ways of financing business and

raising funds: new instruments, new types of contracts, and new institutions regularly emerge in a financial system made up of profit-seeking units.”⁸ The result is a “game” in which “the authorities impose interest rates and reserve regulations and operate in money markets to get what they consider to be the right amount of money, and the banks invent and innovate in order to circumvent the authorities.”⁹ Thus, according to Minsky, circumvention of the regulations and the constant evolution of banking caused the reemergence of financial instability in the 1970s.

For the future, the implications are clear: even if we successfully introduce new, efficient, global and/or national banking regulations that successfully reduce financial fragility, it is unclear how long the regulations would remain effective before the banking sector evolved to circumvent them.

The situation in which we find ourselves today calls for increased empirical knowledge about the interaction between the banking sector and regulations. Moreover, it calls for a renewed assessment of past and previous regulations unconstrained by the doctrines of pre-crisis orthodoxy.

The Swedish Case

We argue that there is much to learn from the Swedish case in this situation. The banking regulations implemented by Sweden after World War II were increasingly circumvented in later decades before being dismantled entirely in the 1980s, followed by a severe financial crisis in the early 1990s. In this book, we focus primarily on the regulation and development of the Swedish banking system. However, no national financial system is an island. Indeed, in our example, the Swedish financial system has been closely connected to the development of banking in international markets, especially the European countries.

In recent years, there has been substantial international interest in the Swedish banking sector. In his book on international banking development, Richard Grossman found Sweden to be “an appropriate subject for an in-depth study of banking evolution” together with the USA and Great Britain. After the financial crisis of 2007–2008, Sweden’s

crisis and recovery experiences in the 1990s were intensely scrutinized in international media. The *Washington Post* called Sweden “the rock star of recovery,” arguing that its recovery provided important insights for the rest of the world.¹⁰ Bloomberg published a piece on its website titled “Scandinavia’s Banks Hold Crisis Lessons World Can’t Ignore.”¹¹ As the 2007–2008 crisis was unfolding, the decision of the American government to bail out the ailing big banks was criticized, with the Swedish government’s temporary nationalization of banks in 1992 cited as a counterexample. The *New York Times* wrote about “Stopping a Financial Crisis, the Swedish Way.”¹² Economist and blogger Brad De Long wrote about stopping the financial crisis through “Nationalization (a la Sweden),”¹³ an idea that was seconded by fellow economist and blogger Paul Krugman, who advocated “Sweden-style temporary nationalization.”¹⁴

We argue that both the crisis in the Nordic countries in the 1990s and the crisis in the USA in 2007–2008 had deep roots. The regime change that took place in the 1980s, with its deregulation of the banking sector, was the culmination of a decades-long banking evolution. Therefore, to understand these crises, we must go back and study the evolutionary process of banking since the early twentieth century, particularly the developments following World War II, the reemergence of financial instability in a nominally regulated setting in the 1960s and 1970s, and the deregulation movement of the 1980s. If there is much to learn about Sweden in the 1990s, then there is also much to learn from its postwar history and the evolving relationship between regulations and banking. Sweden allows an in-depth study of this process because the archival material is available from both the central bank and private banks.

Several studies on the topic of this book have been published in Swedish. One of the most comprehensive studies of the Swedish financial system is described in Mats Larsson’s book, *Staten och kapitalet* (*The state and the capital*). His work takes as its starting point the different roles assumed by the state in the financial system: an owner, a regulator, a controller, a lender of last resort, and a purchaser of financial services. The author argues that there are strong links between these different roles and that a change in one or two of the roles can have

a strong impact on the others. This is obvious during financial crises and in times of regulatory regime change.¹⁵ The present book, however, extends the analysis in light of the global financial crisis and the present discussion on banking regulation.

The main reference work on Swedish financial and monetary policy is the anthology *Från räntereglering till inflationsnorm (From Interest Rate Regulation to Inflation Norm)*, published in 1993. In particular Lars Jonung wrote a chapter that examines the banking regulations that were introduced in the post-World War II period and removed in the 1980s. The present authors find much to admire in the chapters in this volume, but parts ways with them on the fundamental issue of how to view regulations. The previous works are linked to the orthodoxy of the time in which they were written; accordingly, the assumption is that banking is essentially like any other market and therefore a priori should not be regulated. We contend, however, that the interpretation of capital markets as inherently efficient and equilibrium-seeking is problematic. This does not mean that the regulations of the post-World War II era should be a model for the future but rather that we need to reassess the experiences with these regulations in light of the recent financial crisis. We thus argue that the events of recent years have challenged the old orthodoxy to the point that a new study on the experiences of the Swedish banking regulations is necessary.

The Nature and Rationale of Banking Regulations

The need to regulate the financial sector arises from two assumptions. The first is that the financial system is critical to the economy. The second is that, judging from historical experiences, the financial sector is unstable.

Banks are a major source of credit in the economy. In Sweden in 2016, direct lending by banks accounted for half of all credit extended by financial institutions.¹⁶ Nearly as much

credit—43%— was extended by mortgage banks many of which are subsidiaries of banks. Credit is important for several reasons. First, it allows entrepreneurs to fund new business projects that have the potential to increase economic growth and employment. Second, it allows existing businesses to expand or, through the extension of short-term credit, to manage business transactions more smoothly. Third, it allows individuals to make purchases that would otherwise have to be delayed until they had saved enough to afford them. The most important, by far, of such purchases is housing. The extension of credit to individuals to enable large purchases generates demand for products in the economy, which in turn generates production and employment. This connection between banks and general economic activity in society explains why the economic problems of banks, which may cause them to reduce their lending to the economy, is highly likely to lead to problems for the entire economy: if credit is reduced, it is likely that the economy as a whole will experience a downturn.

Banks also manage a large part of the payment system. They operate ATM machines that supply cash to the public, and they transfer payments between accounts after transactions made with cheques or debit cards. These activities mean that banks, as private for-profit enterprises, are managing a part of the infrastructure that is necessary for a society to function.

The two factors described above—the importance of banks for economic activity and for upholding the payment infrastructure—explains why society has a substantial stake in ensuring that the banking sector is managed in a sustainable manner. If the banking sector could independently guarantee both a stable supply of credit and a stable payments system, regulations would not be necessary. However, experience suggests that the banking sector cannot manage these important social functions without socially imposed regulations.¹⁷ Some of the reasons are discussed below.

Banks are highly interconnected. One reason for that is direct: they tend to lend to one another. If a large bank runs into trouble, it is possible that the banks that lent money to it are in trouble as well. The other reason lies in the risk of contagion. If one bank fails lenders, then either depositors or wholesale lenders such as money market funds may start

withdrawing money from other banks as well. The reason is that since lenders do not know the financial status of their banks, they may rush to withdraw their money, thereby creating a financial crisis that was not initially there, in a case of self-fulfilling prophecy.

Another inherent instability of the banking sector lies in its business model. Banks earn profits through lending and therefore have an incentive to maximize lending. Lending, however, is constrained by the ability of borrowers to repay their loans. If a bank lends too aggressively, it will sooner or later lend to enterprises and individuals who are unable to repay their debts. An adverse shift in the general economic performance of the economy, which the banking sector cannot directly control, can lead to increasing unemployment and lower profits for firms, which in turn might sharply increase the number of loan defaults. If a large enough share of a bank's borrowers are unable to repay their debts, the bank will become insolvent. There is thus a risk that banks will overextend themselves and become vulnerable. Aggressive lending can also create unsustainable asset bubbles when borrowers bid up prices with borrowed money; these bubbles eventually burst, creating further financial instability.

The systemic importance of banks means that, in terms of economic theory, the cost of bank failure is much more expensive for society than for the individual bank. Banks can, therefore, be expected to invest less in stability than would be optimal for society as a whole. Because of the presumed high social costs of bank failure, it is often deemed necessary for governments to step in and save banks in crisis. These banks are, as the saying goes, "too big to fail." This perspective gives rise to a moral hazard problem: Banks may take excessive risks on the premise that governments will bail them out in the event of trouble. Such bailouts can result in costs to taxpayers. This conundrum suggests the need for regulation to bring banks' investments in stability closer to a social optimum.

In conclusion, banking is inherently risky, and the above factors explain why regulations may be necessary to ensure financial stability, which is not profitable enough—at least in the short run—for the individual banks to ensure it.

The Concept of Macroeconomic Regime

Throughout this book, we find it useful to apply the concept of a macroeconomic regime. The main attraction of the concept is that it captures the phenomenon that financial regulations are never implemented in isolation but rather occur together with other changes in monetary policy and other areas of policymaking. Thus, a macroeconomic regime can be described as an overarching goal that establishes the principles for how the relevant markets will be regulated and how monetary policy is conducted. Peter Temin defined it as “the underlying principles that determine most actions.”¹⁸ Douglas Forsyth and Ton Notermans refined the concept, stating that a regime comprises both an overarching goal and a set of policy instruments—including regulations—to achieve that goal. They identify three major regimes from 1920 to today: the interwar gold standard, from 1920 to the mid-1930s; the high-growth and -employment regime, from the 1930s to the 1970s; and the disinflationary regime, from the mid-1970s to roughly the present.¹⁹ For the sake of brevity, we refer to these regimes as the Classical Regime, the Statist Regime, and the Market Regime.

Each of these regimes had an overarching macroeconomic goal and a general view of the role in society of the banking sector. The Classical Regime was dominated by the classical *laissez-faire* mindset. Central banks were independent of the government and guaranteed the purchasing power of currencies. The banking sector was relatively unregulated. The overriding priorities were low inflation and stable currencies, which motivated a restrictive monetary policy. The Statist Regime, in contrast, subjected central banks and the banking sector to a list of politically determined goals. Policy was guided primarily by goals for growth and employment. To reach these goals, the economic policy had to be adjusted nationally to address specific problems. In the financial market, these adjustments included a low interest rate policy, credit control, and increased governmental control of the financial sector.

The Market Regime saw the reemergence of beliefs in the inherent efficiency of markets, the deregulation of banking, the return of independent central banks, and the primacy of inflation targeting.

State restrictions were abolished, and market forces became the prime mover in the financial sector.²⁰

A macroeconomic regime is usually based on, or draws legitimacy from, some political and theoretical orthodoxy. Thus, the Classical Regime can be associated with classical liberalism and economic theory; the Statist Regime with Keynesianism and state-oriented policies; and the Market Regime with what is commonly referred to as neoliberalism and more market-oriented theories, such as monetarism, public choice, and the efficient market hypothesis.

Since a functioning financial system is a prerequisite for the economic development and the welfare of a nation, it is crucial for macroeconomic regimes. For this reason, financial markets have often been subject to regulations and controls consistent with the aim of macroeconomic regimes. However, the all-encompassing structure of a macroeconomic regime is general economic policy, which is often based on economic theory or specific aims, such as currency stability. Nonetheless, developments after World War II showed that regulations and guidelines for the financial system are an important part of the macroeconomic regime. The macroeconomic regime therefore includes a sub-regime that is specifically focused on the regulation of the financial sector. We refer to this as a financial regulatory regime to distinguish it from the broader concept of macroeconomic regime.²¹

The regulatory regime is also connected to other measurements in the financial sector—for example, currency stability. Hansjörg Herr focuses on the development of international monetary relations after the collapse of the Bretton Woods system. He notes the vital importance of the international currency structure for the success of national economic policy, for example, in trade or income policy.²² Obviously, changes in currency regulation not only have a strong impact on international financial relations but also, as we discuss later, affect the activities of actors in a national financial market.²³ Thus, currency regulation and other financial activities are closely related to general economic policy. Together, policy goals and regulations form a financial regulatory regime, which indicates that the financial regulatory regime comprises a mixture of macro and micro measures.

Financial markets are to some extent regulated, either through legislation or through agreements among market actors. The definition of a

financial regulatory regime is directly connected to the role of the official policy goals and the implemented policy. Thus, financial regulatory regimes can be divided into three ideal types that reflect the role of governmental regulation and control.²⁴

The *free banking regime style* does not involve any extensive governmental activities; rather, market mechanisms and self-regulation govern the development of the financial system. The early banking systems of Europe and the USA in the eighteenth and nineteenth centuries, before the advent of modern central banking and banking regulations, come closest to this style. The opposite financial regime style is the *totalitarian regime style*, in which the financial system is completely integrated into economic policy. This regime includes detailed legislation and other measurements to govern the market and leaves very little leeway for individual activities by actors in the financial market. The financial systems of the Soviet Union and pre-reform Communist China come closest to this style. The third financial market regime style is the *semi-regulated regime*, which involves governmental legislation of a different character, for example, laws that limit market activities and the size of lending. Most developed economies use some form of semi-regulated regime for their financial system. It enables the government to combine legislation that promotes the stability of the financial sector with regulations that integrate the financial system with macroeconomic policy or counteract direct crises.

Thus, the semi-regulated style includes a wide variety of regulatory regimes wherein governments perform different activities, including the enactment of legislation and performance of lender of last resort activities, ownership, and control. The mixture of these activities reflects different degrees of governmental guidance.

Although the composition of regulatory measures reflects the aims and wishes of the state, legislation in a semi-regulated regime might not always be totally consistent. Regulatory measures could encourage certain new business activities while hampering others. In the same way, regulatory measures might be designed either to promote structural changes such as mergers and acquisitions or to hamper these activities.²⁵

Aim of the Study

The overall purpose of this study is to analyze the development of the Swedish financial regulatory regime from the early twentieth century to the present day. Our particular focus is on the period following the Second World War. In the late 1940s and early 1950s, new regulations and restrictions implemented in the financial market were closely connected to governmental policy aims. These restrictions implied extensive control of the financial market—including not only banks but also insurance companies—and served as a complement to traditional legislation, which regulated, for example, bank establishment, business activities, and accounting (see Chap. 2). These regulatory measures, which were implemented by the Swedish central bank (the Riksbank), were important components of government policy for 30 years, lasting until the deregulation of the financial market in the early 1980s.

The political side of financial regulation is important, and the period of analysis is an exceptional one. During the years 1950–2015, the regulation of Sweden's financial system underwent two fundamental changes, going from a period of relative freedom to one of strict control, then, in the 1980s, back to a more liberal financial market. These changes were linked directly to general government policy. Thus, the regulatory regime during 1950–1980—with few exceptions—coincided with the reign of the Social Democratic Party. When the Social Democrats came to power again in the 1980s, it presided over a change in policy and continued to deregulate the financial market.

This development will be analyzed to answer several questions that are relevant today. First, how was the Riksbank regulation constructed, and what role did the banks play in its construction? In this regard, a key issue is the degree to which the banks were able to extract benefits from these regulations. Should we view the regulations as being forced on the banks from above or as a process in which special interests were able to capture the regulatory apparatus for their own benefit?

Other questions relate to shadow banking and regulatory dialectics. To what extent were the banks able to circumvent regulations? How did they circumvent regulations in practice?

At present, there is concern that the new regulations will harm economic growth. We therefore ask the following question: what were the economic consequences of the Riksbank regulation?

Outline of the Study

In Chap. 2, we present the political and economic background of the postwar regulatory regime in Sweden. The great depression of the 1930s had profound effects on political and economic establishments and on the theoretical framework for understanding finance and banking. In Sweden, these effects coincided with the beginning in 1932 of the long hegemonic position of the Social Democratic Party as the dominant—although far from unrivaled—political force in Swedish society. The outbreak of World War II and the introduction of war finance served to further accentuate these tendencies. After the war, the Social Democratic government prepared to reshape Sweden into the “People’s Home” (*Folkhemmet*). Chapter 2 also discusses the political and economic landscape of the late 1940s, when the new regime took shape. The main question addressed is the degree to which these changes were driven by ideology and/or pragmatic interpretations of the situation.

Chapter 3 discusses the introduction of the regulations enforced by the Swedish central bank, the Riksbank, and its political background. It analyzes the game played by the Ministry of Finance, the central bank, and the commercial banks and explores how the regulations were created through these negotiations. A key question is the degree to which the banks were able to extract benefits from these regulations. Should we view the regulations as being forced on the banks from above or as a process in which special interests were able to capture the regulatory apparatus for their own benefit? This question has a consequential role in the discussion of the nature of regulation.

Chapter 4 focuses on the interaction between the economic development of the period and the regulatory setting. It begins by examining the internationalization of central banking and the end of interest rate policy, followed by the increased tension between the banks and the central bank.

Chapter 5 examines regulatory changes both in Sweden and internationally. Domestically, several factors gradually changed the banking landscape, which led to adjustments to the post-World War II regulatory framework. Internationally, the main topics covered are the crumbling of Bretton Woods and the oil crisis. These events set the stage for dramatic changes in the Swedish banking sector

Chapter 6 discusses the deregulation of Swedish financial markets and the introduction of the Market Regime. The driving forces behind this regulatory change are analyzed, along with its consequence in Sweden: the financial crisis of the early 1990s. The experience of this crisis is analyzed in detail, especially the manner in which Sweden handled it, which received much international attention.

Chapter 7 describes developments after the crisis in the 1990s through 2015. The Swedish banking sector expanded considerably, especially with respect to its cross-border activities. The global financial crisis in 2008 placed stress on the sector, particularly because of its engagement in the Baltic States, and a series of precautionary steps were taken by the Swedish government and the Riksbank. A global re-regulatory agenda implemented after the crisis has been very important to the Swedish financial system.

Chapter 8, which concludes the book, summarizes the long-term consequences of the different regimes. It explains how the banking sector adjusted to the regulations and the extent to which the regulations harmed competition. This chapter also analyzes the consequences of deregulation in the 1980s. It ends by considering the question of whether a new macroeconomic regime is being initiated.

Notes

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15. Larsson, *Staten och kapitalet*.
16. Sveriges Riksbank, *Svenska finansmarknaden*, 63.
17. The passage that follows is based on Llewellyn, "Economic Rationale for Financial Regulation".
18. Temin, *Lessons from the Great Depression*, 5.
19. Forsyth and Notermans, *Regime Changes*, 41–42.
20. Forsyth and Notermans, *Regime Changes*, 41–42.

21. Forsyth and Notermans, *Regime Changes*; Perez, “‘Strong’ States and ‘Cheap’ Credit”.
22. Herr, “International Monetary System and Domestic Economic Policy”.
23. For an extensive discussion about regime changes, see Forsyth and Notermans, *Regime Changes*.
24. The following discussion about regulatory regime styles is based on Goodhart and Illing, “Introduction”; Larsson and Wallerstedt “Reglering av bank”.
25. Llewellyn, “The Economic Rationale for Financial Regulation”; Llewellyn, “A Regulatory regime for Financial Stability”.

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2

The Transition from the Classical Regime to the Statist Regime: 1900–1950

Abstract The political and economic background of the postwar regulatory regime in Sweden is discussed in this chapter. The great depression of the 1930s had profound effects on the political and economic establishments as well as on the theoretical framework of economics. In Sweden, these effects coincided with the beginning in 1932 of the long hegemonic position of the Social Democratic party as the dominant—though far from unrivaled—political force in Swedish society. The outbreak of World War II and the introduction of war finance further served to accentuate these tendencies. After the war, the Social Democratic government prepared to reshape Sweden into the “People’s Home” (*Folkhemmet*).

Keywords Gold standard · Social democracy · Sweden · Banking regulation

The story begins during the Classical Regime. Sweden adopted the gold standard in 1873 in a monetary union with Denmark and Norway. Its central bank, the Riksbank, was created as a private for-profit bank in 1657

but, after going bankrupt, was taken over by the government in 1668. Government ownership made the Riksbank different from central banks elsewhere; in some countries, central banks were not nationalized until after World War II.¹ With the growth of the banking sector, the government and the Riksbank gradually began to find their respective roles in the financial system.

Historical Background of the Swedish Banking Sector

Economic growth in Sweden accelerated after the 1860s, especially during the decades around 1900, when it was very high compared with other European countries. At the same time, urbanization increased along with the need for new dwellings and developed public services. Between 1893 and 1900, industrial production approximately doubled, primarily through expansion of the engineering and pulp industries. This growth increased the demand for capital as well as the need for a smoothly working financial system. As early as the 1880s, structural problems in the functioning of the financial system were identified, one of which was lack of capital. At the end of the nineteenth century and beginning of the twentieth century, Swedish foreign debt increased rapidly and was among the highest in the world on a per capita level. This capital was used primarily to establish the national infrastructure. However, from a national perspective, it was necessary for Sweden to meet the general need for capital using available resources. This was accomplished through a combination of governmental involvement and regulations and with the help of financial intermediaries on the open market.²

To develop the financial market and make it easier to acquire capital for investments, several fundamental legislative changes were made during the last decade of the nineteenth century and in the early twentieth century. Of fundamental importance was the Riksbank's concentration on central banking activities, which left lending on the open market to banks, savings banks, and insurance companies. The Riksbank focused instead on interest rate policy and note issuing, which was centralized at the Riksbank in 1903.³

By 1892, savings bank legislation had been revised. The revised law included several limitations on savings banks' activities. Specifically, their lending was to focus on private persons and small-scale businesses, such as family farms and handicrafts. It was important that the savings banks' capital be invested safely, including in bonds. The majority of the savings banks' deposits came from the working and middle classes. Savings banks were seen as important players in the fostering of discipline and education among the working class in particular.⁴

Introduction of Early Regulations

The regulation of banks and insurance companies also underwent extensive changes in 1903. For insurance companies, the 1903 legislation was the first law to address both mutual and joint stock companies. The new law was initially planned to be implemented in the 1880s, but a desire to coordinate Swedish regulation with new legislation in Denmark and Norway delayed its introduction. The new insurance law eliminated the differences between mutual and joint stock companies and thus stabilized the entire insurance industry. Of special importance was stricter regulation of life insurance companies' investments to help secure policyholders' capital.⁵ The 1903 insurance law was replaced by new legislation 1948.

New legislation for banks was also introduced in 1903. Compared to insurance companies, banks were given a larger degree of freedom in their investment activity as well as in their ordinary business. Through the regulation of liquidity and solidity, banks were more economically stable than they were before the legislation. Thus, the capital requirements for establishing banks were increased, which led to a merger wave among the smaller banks. The stricter capital requirements were intended to make banks more resistant to economic turbulence and hence lower risk in the financial system. This goal was consistent with the wishes of both the government and the newly established Bank Inspection Board (*Bankinspektionen*), which was responsible for bank supervision.

The bank legislation of 1903 was in place for only eight years; in 1911, a new bank law was introduced that imposed stricter liquidity requirements. The new legislation also opened the door to a new business activity because it gave large banks permission to own and trade shares, albeit with certain restrictions. Behind this new regulation lay the German model of universal banking, which had supporters in Swedish industry and among the large banks. From a general perspective, the Swedish legislation was ahead of regulations in several other European countries, especially in the promotion of economic stability and liquidity among banks. The bank legislation of 1911 remained in place until 1955, when a new regulation was enacted that in large part was identical to or based on the 1911 law.⁶

As discussed above, the Swedish financial system underwent extensive changes around 1900. Increased demand for capital in local communities and industry and for infrastructure investments had increased pressure on the financial system.

New legislative measures were introduced as a means to address these issues, resulting in a more controlled but better secured financial system. These regulations resulted in a financial system in which banks were the main providers of capital for industry and trade while savings banks extended credit to individuals and small-scale businesses. Together with the insurance companies, the savings banks also purchased bonds issued by the state, mortgage companies, and private enterprises. The state, primarily through legislation and bank and insurance inspection boards, propelled a gradual change from self-regulation to a larger degree of state control. In addition, the different actors in the financial market were locked into specific customer groups for several decades.

Problems and Crises of the Early Twentieth Century

For decades before World War I, the gold standard had been associated with financial stability. National currencies and the domestic purchasing power of money were convertible into gold at a fixed value. This regime, which was intended to automatically adjust imbalances in financial

flows between countries, was the embodiment of the established orthodoxy at the time. In today's terminology, it was a disinflationary system that favored stable currencies over high employment. Central banks, most of which at that time were privately owned, were viewed as technical institutions that upheld a mostly automatic operating system. However, research has shown that the gold standard, in contrast to its official image, was not an automatic system but instead relied on constant interventions by and cooperation among national central banks.⁷ Nevertheless, the official image provided considerable legitimacy for central banks and freedom from political interference in the realm of finance.⁸

With the outbreak of World War I in 1914, a number of countries, including Sweden, took their currencies off the gold standard. As World War II would do later, the First World War profoundly changed the setting of both the international and Swedish political and economic landscapes. War regulations forced the government to take a more active role in the economy, leading to government intervention on a scale previously unseen. Politically, food riots and the revolution in Russia sent shockwaves across the world. An extension of the franchise removed the acute threat of revolutionary efforts by the Social Democratic Party, which had been created in 1889, and set it on the path of political reformatory hegemony. Its more orthodox Socialist wing broke out and formed a more revolution-oriented party. A similar split of the Socialist movement occurred internationally.⁹

In the years after the war, Sweden was hit by a deflation crisis. Large credit extensions to the business sector led to massive losses for banks. Two of the largest banks, *Svenska Handelsbanken* and *Skandinaviska Kreditaktiebolaget*, barely managed to avoid government injections of capital in exchange for ownership. Debentures were issued and pragmatic exceptions from regulations were granted, allowing the banks to treat the debentures as equity to fulfill their capital requirements. The government did, however, nationalize the failing agricultural bank *AB Svenska Lantmännens bank* and injected capital in *AB Nordiska Handelsbanken* in exchange for half ownership. It is likely that the government's demonstrated willingness to inject capital into banks when needed lent confidence to the banking sector and helped to stem the crisis.

The deflation crisis led to discussion about the need to increase regulation. In 1922, the head of the Ministry of Finance stated that it was “obvious” that the banking system was flawed, especially because of “the risks and other inconveniences...connected to the banks’ liberal financing of speculations in securities.”¹⁰ However, he added that “it is not equally obvious which actions can and should be taken in order to establish a more sound economic order...”¹¹ A government committee, delivering its results in 1927, voiced concern that liberal credit extension resulted in both massive losses for banks and inflationary tendencies. However, as the deflation crisis faded toward the mid-1920s, the regulatory momentum was lost and only marginal regulatory changes were made.¹² Nevertheless, the direct interventions and the discussions about a tightening of the bank regulatory framework can be seen as the first signs that the comparatively liberal approach consistent with the Classical Regime was starting to unravel.

The Origin of a New Economic Policy

The economic troubles of the early 1920s led to increased criticism of the economic system. Some viewed the experiences of the war economy as a blueprint for a functional non-capitalist planned economy. There was also criticism of the principles of the gold standard. In 1923, John Maynard Keynes called the gold standard a “barbarous relic” that was not up to “the requirements of the age.”¹³ Nevertheless, countries reverted to the gold standard, including Sweden, officially, in 1924. In many countries, the reversion was followed by deflation and severe contractions, but in Sweden, the price of reversion was relatively small. The reason for the difference was probably that the deflation crisis of 1920–1922 had already done much of the disinflationary work of the regime.¹⁴ Regardless, the gold standard could no longer guarantee financial stability. The reasons that the gold standard in the interwar years did not function as well as it had before the war have been widely debated.¹⁵

The postwar crisis of the 1920s was not enough to break the gold standard regime. However, the crisis that started on the New York Stock

Exchange in 1929 and developed into the Great Depression proved to be sufficient. Great Britain went off the gold standard in September 1931. The Swedish government, assisted by a large loan from Marcus Wallenberg, the head of the *Stockholms Enskilda Bank (SEB)*, made a desperate effort to cling to gold but relented within a month. The subsequent rapid devaluation of Swedish currency likely gave exports a boost and helped Sweden to make a comparatively quick economic recovery.

On the political scene, the dominant event was the beginning of the Social Democratic hegemony, which remained the main government-controlling party until 1976. Through a deal with the Agrarian Party, Social Democrats were able to form a government in 1932 and began to initiate public work projects to increase employment.

The economic policy implemented by the Social Democrats in the 1930s, its inspiration and its effects have been topics of lengthy debate.¹⁶ Did the policy emerge from the old theoretical framework of socialism and its insistence on the recurring crises of capitalism? Or was it spawned by the new economic ideas associated with British Liberals such as Keynes or the home-spun Swedish Stockholm School? The Marxist doctrine, out of which Social Democracy emerged, did cite the periodically recurring lack of demand as a key flaw of capitalism that would eventually lead to its demise. However, the notion that the goal was not to overthrow the existing order during a crisis but rather to actively manage the system was a profound break with Marxist doctrine. This notion had been discussed sporadically by Social Democrats at least since 1908.¹⁷

Another major ideological influence was developments among liberals in Britain who started to question the tenets of classical liberalism in favor of what they considered a more socially responsible liberalism. Bertil Ohlin, a key member of the “Stockholm School,” was deeply influenced in his youth by Keynes’ 1926 book, *The End of Laissez-faire*.¹⁸ Another book produced by British Liberals (with the involvement of Keynes) was the 1928 British Liberal Party manifesto, the so-called *Yellow Book*. This book was well received by Swedish Social Democrats, who viewed it as confirmation that their gut-felt suspicions about unfettered capitalism could be intellectually supported. Tage Erlander, the Social Democratic Party leader and prime minister

from 1945 to 1969, expressed the relationship among Swedish Social Democracy, *The Yellow Book* and theory in the 1930s as follows:

A bridge had been built over the gap between Socialism's will to act and its demand that its policies should rest on a solid theoretical ground. ...The battle between Liberalism and Socialism belonged to the past... *The Yellow Book* did not contain anything new to us Social Democrats. It reconnected to thoughts that had been present earlier in the workers' movement, but it filled us with self-esteem. It was we who had the real theory, not our opponents. Our satisfaction became even greater when, during the 1930s, the young Swedish economists Gunnar Myrdal and Bertil Ohlin supported the theory of active employment. The era of ideological bewilderment was over.¹⁹

The Social Democrats and Financial Regulation in the 1930s

In finance, the main event was the so-called Krueger crash in 1932. Ivar Kreuger built a financial empire based on financial innovation and fraudulent accounting. In 2007, the *Economist* anointed Kreuger “the patron saint of sinners” and “arguably the most brilliant and ambitious swindler who ever lived.”²⁰ In exchange for a grant of a national monopoly on the production of matches, Kreuger offered loans to governments around the world. The money came from investors and banks who bought into the scheme because they expected the match monopoly to generate huge profits. This scheme sounds far-fetched today, but one must bear in mind that this was an era in which a large part of the population were habitual smokers and cooking was done with gas ovens. When the profits failed to materialize, Kreuger attempted to keep his empire afloat by borrowing increasing amounts of money, paying out dividends to investors using borrowed money. In 1932, when the situation became unsustainable, Kreuger shot himself, unleashing a fall in the value of stocks and securities that were to a large extent owned by banks in Sweden. The losses threatened the survival of the banks. For the fledgling Social Democratic government, the situation was

problematic: Should they assist in a bailout of profligate financial capitalism in the middle of a depression? The answer was yes. The Minister of Finance, Ernst Wigforss, defended the bailout by saying that the demise of the ailing banks would cause too much damage to the economy.²¹ In other words, the fledgling Social Democratic government followed the doctrine of “too big to fail.”

A month after Kreuger’s suicide, a government commission was created. The continuity from earlier decades was clear. The commission returned to the question that had been left unresolved after the deflation crisis in the 1920s and acknowledged the ideological problem of regulation:

Legislation is here faced with the delicate task of making a trade-off between, on the one hand, the interest of the public in exercising control over the banks...and, on the other hand, the interest of the banks to be allowed, like any other private enterprise, to freely operate their business without restrictions that might hinder their sound development.²²

The result, however, was a tightening of the regulatory framework, including the abolishment of banks’ right to own and speculate in stocks.²³ It is unlikely that the 1932 regulatory reform was linked to the ideological vision of Social Democracy; rather, it was a continuation of concerns that went back at least to the beginning of the century. The events of the 1930s provided enough momentum to push through the changes. Compared to the regulations that had been introduced in the USA—some of them also following the Kreuger debacle—the Swedish financial markets can still be described as liberal in the traditional sense.²⁴

On the macrolevel, the gold standard had a pseudo-existence, with its resumption deferred year after year. Relying on advice from academic economists, a price-level targeting system that has been described as a precursor of the inflation targeting of later decades was attempted. Instead, however, the currency was soon fixed to the British pound, because at that time Great Britain was the largest trading partner. The task of monetary policy, however, still lay very much in the hands of a relatively independent central bank. The governor of the central bank

at the time, Ivar Rooth, wrote in his memoirs that he experienced no major conflicts with the Social Democrats during the 1930s.²⁵

The indefinite deferment of the gold standard led to a vacuum in the framework of monetary policy. Dag Hammarskjöld, the future leader of the United Nations, was already working at the Department of Finance when he was recruited to the Riksbank as Rooth's advisor. In 1935, Hammarskjöld presented a lecture at a meeting of the Swedish Bankers' Association in which he expounded on monetary policy without the gold standard. The advantage of the gold standard, he argued, was that it functioned like an automatic machine that legitimized non-interference by politicians in the realm of monetary policy. Without the gold standard, there was nothing to prevent interference from politicians. A new source of legitimacy and guidance for monetary policy was therefore to be found in the emerging profession of economists like him, who were lending central banks their expertise.²⁶ As mentioned above, subsequent research has shown that the gold standard did not actually work in this way, but Hammarskjöld was probably right to recognize the rhetorical power of the supposed machine-like character of the system. In a telling anecdote, a British cabinet member, when told that Britain went off the gold standard, is said to have exclaimed, "Nobody told us we could do this!"²⁷ In the 1930s, politicians and economists gradually became accustomed to the notion of a functioning economy without the gold standard.

As they did with financial policy, the Social Democrats in the 1930s mostly continued the housing policy of earlier years. However, housing started to emerge as the main concern and would become a matter of great importance in the financial system after World War II. In their highly influential book, *Crisis in the Population Question* (*Kris i befolkningsfrågan*), Gunnar Myrdal and his wife, Alva (the former already a professor of economics and an important advisor to Wigforss), identified the construction of a large amount of new housing as a foundation for raising the national standard of living. Construction was also associated with maintaining employment levels, and public works carried out by the government included

construction of housing. A government investigation resulted in the introduction of various subsidies for housing for the poor.²⁸

In the second half of the 1930s, the depression had given way to boom times in Sweden. Most likely, the devaluation that occurred after the *krona* was taken off the gold standard and the exchange rate was fixed against the pound gave a significant boost to the economy.²⁹ The deflationary pressure of the early 1930s eventually gave rise to inflationary pressure. Concerns about inflation—also voiced within the labor movement because of fear that real wages were falling—led to renewed interest in how to organize the Swedish financial system and monetary policy.

A 1937 parliamentary bill produced nothing concrete, but within it can be found many of the pieces that would eventually comprise the Post-World War II regime. Wigforss attached a memo to the bill that provides a glimpse into the development of the thinking at the time. Keeping inflation in line was still seen as the number one priority because of concerns that the public's wages were being eroded. Another concern was the bullish stock market. Wigforss noted that both revaluation of the currency against the pound and restrictions on the extension of credit might become necessary to curb inflation. The tools he had in mind to restrict credit extension were a mix of old and new. The central bank could raise the interest rate and conduct open market operations, whereas the government could overbalance the budget, presumably by raising taxes or reducing or eliminating tariffs. A transaction tax on stocks to mitigate speculation on the stock market was also considered.³⁰

Notably, Wigforss cautioned that actions taken to reduce inflation had to take into account “risks of diminished employment and diminished output.”³¹ Although the overall responsibility of the central bank to guard the purchasing power of money was affirmed, he added that it was on the condition that “all of the government's actions that influence the economy...are coordinated so that they support and do not contradict each other.”³² Wigforss' words were careful, but their meaning was clear: the independence of the central bank to fulfill its mission as it saw fit was *de facto* constrained.

World War II

In September 1939, World War II broke out. Increased imports to Sweden caused by the hoarding of foreign goods in expectation of import restrictions placed a strain on foreign currency reserves. Foreign investors withdrew their investments in Sweden, which further increased the pressure. The Riksbank took action to restrict the outflow of foreign currency, and agreements were made with commercial banks to provide foreign currency only for purposes deemed legitimate.³³ This was in practice a rationing of foreign currency, with commercial banks assisting in administration of the rationing procedure. Similar use of private businesses and organizations to administer war regulations had taken place during World War I.³⁴ Import restrictions further helped to control the outflow of funds.

In the first phase of the war, there was a squeeze on financial markets. People withdrew deposits from banks, and businesses borrowed more money than usual in order to hoard raw material. This behavior resulted in upward pressure on market interest rates. Soon, however, the financial situation in Sweden was characterized by an excess of funds, since few investments were made and the public was once again depositing their money. This drove down interest rates, especially since it was impossible to place money abroad. Commercial banks were, therefore, more than happy to oblige the wartime expansion of government expenditure because they needed to place their money somewhere. By 1942, half of the government's excess spending over income was financed directly by commercial banks.³⁵

When the balance of the war seemed to swing conclusively in favor of the Allies, planning for a Swedish future in a postwar world began. The experiences following the end of World War I and the subsequent deflation crisis were still very fresh in the minds of politicians and the public. There was widespread concern that another economic slump would occur after World War II. High employment levels had been established as an important priority in the 1930s, and active policies were prepared with the goal of avoiding a depression. These policies were bound to create tension with the prewar orthodoxy. A committee established by

the Riksbank in 1943 wrote that a deflationary process that aimed to restore prewar price levels would “come into conflict with the demands of maintaining full employment, which is a crucial part of the monetary program such as it has developed during the last decade.”³⁶

The Social Democratic Postwar Program

As mentioned above, the Social Democratic government had been fairly moderate in its policies during the 1930s. In many ways, it simply continued the policies of earlier decades. There was never an open commitment to abolish the gold standard but rather only a continual suspension of it. The war years saw the formation of more radical ideas. A joint statement by the organizations that composed the Swedish labor movement was published in 1944 under the title *The Labor Movement's Postwar Program (Arbetarrörelsens efterkrigsprogram)*. The committee that produced the program was chaired by Wigforss and had Gunnar Myrdal as its primary expert. The program description began with the following statement:

The world in which our people will live, once peace has been restored, must largely become an entirely new world. The prewar economic system will not be able to solve the problems that the future will hold. It gave rise to constantly recurring crises with unemployment and diminished production.³⁷

The experiences from the war, when social coordination of the market economy had been able to assure a functional economy, were explicitly mentioned as a blueprint for the postwar era.

The main priorities of the future were explicitly identified: full employment, fair distribution, higher standards of living, and higher efficiency and more democracy in the private sector.³⁸ The postwar program also took a clear position on keeping inflation in check. The very first of the 27 points proposed to achieve the stated goals was to ensure stability of prices, avoiding both postwar inflation and deflation. The program espoused what Charles Kindleberger has called a “Keynesian”

view of inflation, that is, viewing changes in price levels as being due to real economic changes rather than to increases in the quantity of money.³⁹ A controlled fall in general price levels caused by resumption of trade, removal of wartime monopolies, and increased efficiency was therefore deemed desirable.⁴⁰

An important means of achieving the new society was the low interest rate policy. This policy was part of a business-friendly attitude in which the state would help the private sector to maintain sustainable economic growth by keeping interest rates low.⁴¹ Low interest rates were also important for housing. The interest rate hike at the beginning of the war and increases in the costs of raw materials had resulted in reduced construction, which led to wartime efforts to revitalize it.⁴² The postwar program not only described housing construction as an important social concern in line with the Myrdal book of the 1930s but also asserted that it was a “key industry” necessary to maintain employment and noted that its expansion was thought to explain the higher level of employment in Sweden relative to other countries during the 1930s.⁴³

The financial sector was not directly targeted by the stated goals, but the expanded section on the motivation for the program included several direct plans regarding it. In light of the recurring crises of the preceding decades, capitalism was considered a fickle and unreliable system that fluctuated between speculative excesses and long periods of underinvestment. A general smoothing of the business cycle would not be enough to ensure full employment. Instead, a “general plan for investments in society” was needed.⁴⁴ A new investment body was envisioned in which representatives of different groups in society, including business organizations and labor unions, would work together to develop investment plans. The state was also supposed to develop its own commercial bank. The most radical conclusion concerned insurance agencies; the state was to completely nationalize insurance, “not only in order to extend government influence on the capital market but also because private enterprise in this sector is to some extent economically inefficient.”⁴⁵

The end of the war and the postwar program unleashed what has become known in Sweden as the “planned economy debate” (*planhushållningsdebatten*). Its terminology—pitching planning against free markets—was a direct descendant of the socialist calculation debate that had

occurred after World War I. However, the terminology is misleading. Planning did not mean a Soviet-style command economy but instead referred to the government interventions advocated in the postwar program. The Social Democratic Party had officially abandoned the goal of socialization at the party congress of 1932. Its official goal, and in essence its redefinition of socialism, became to ensure that the inefficiencies of capitalism—its constant fluctuations—were kept in check by the planning efforts of the government and its growing cadre of experts. Opposing this vision was the bulk of Swedish businesses and political opposition in the form of conservatism and the new form of social liberalism. The latter agreed to abolish *laissez-faire*—to the consternation of more classical liberals—but felt that the heightened degree of government intervention in the economy envisioned by the Social Democrats was a step too far. The Social Democratic agenda was thus far from unchallenged.⁴⁶

International Postwar Development

Swedish monetary and banking policies in the years following the war were heavily influenced by international development. Increased skepticism about the notion of the economy as a self-regulating system was an international phenomenon. The new international world order developed at Bretton Woods was the work of “market pessimists”⁴⁷ and aimed to facilitate increased world trade by minimizing exchange rate fluctuations, which were believed to be inevitable in a system based on market-based exchange rates. Although currencies could be converted as part of trade, control over capital flows was allowed and commonly exercised. Finally, the goal of keeping employment and output high was affirmed, and thus individual members of the accord were allowed to depreciate their currency if it was deemed necessary to avoid high unemployment.⁴⁸

As mentioned above, Sweden had experienced large withdrawals of foreign currencies in 1939. Resumption of trade threatened to once again deplete the nation’s currency as a population hungry for import goods regained access to world markets. Furthermore, Sweden, because of its wartime neutrality, was largely kept in the dark concerning the

development of the Bretton Woods accord and its impact on Sweden's postwar future. Considerable uncertainty thus reinforced the ideological motivation to maintain many of the wartime regulations. In 1947, a currency crisis in which the Swedish currency reserves were nearly depleted led to import restrictions.⁴⁹

Toward a New Macroeconomic Regime

The years following the end of the war were characterized by increasing tension between central bank officials, whose mindset had been shaped by the gold standard era, and the advocates of increased state intervention. As mentioned above, the Social Democratic vision for money and banking had been very vague; it did not officially abrogate the gold standard but instead suspended it year after year. Wigforss' memorandum on the 1937 bill contained a hint that monetary policy should be part of an overarching government policy for full employment but was otherwise very orthodox. Mats Lemne, who later became governor of the central bank, thought that the directives to the central bank during these years became "fuzzier and fuzzier."⁵⁰ The reason for this vagueness was probably the government's lack of a detailed plan for what it wanted to do with money and banking.

Nevertheless, events and practical considerations joined ideology to mold the government's policy into the form it would roughly maintain for decades. The large government wartime debt needed to be rolled over; i.e., new bonds had to be issued to replace older bonds that matured. During the war, one of the main tasks of the central bank had been to ensure that the government's bonds could be placed on the domestic market. This continued during the years after the war.⁵¹ Similarly, as mentioned above, there was the fear of a postwar depression. All of these factors contributed to the decision to make maintenance of low interest rates the fundamental postwar monetary policy.

A very similar situation was encountered by most industrial nations after the war. The resulting so-called low interest rate policy was an

important part of the beginning of what became the Statist Regime. Milton Friedman, who devoted his life to dismantling the postwar economic order, stated that during the low interest rate policy era,

the only role assigned to monetary policy was to keep whatever interest rates it affected low so as to avoid interfering with the investment regarded as needed to offset the secular stagnation that was confidently expected to be the major problem for the future.⁵²

Friedman wrote that the shift was caused by two factors: the theoretic revolution initiated by Keynes and “the brute force of events.”⁵³ As we have seen, the direct influence of Keynes should not be overestimated. Myrdal wrote a more or less accurate account of the system that was to emerge by 1944 without mentioning Keynes or any new theoretical developments. Instead, Myrdal derived the new paradigm from the reality of power politics. He argued that the combined interests of governments burdened by unprecedentedly high debts and powerful interest groups in business and agriculture converged in a long-term commitment to low interest rates. To avoid inflationary pressure caused by low interest rates, Myrdal argued, the function of the interest rate to limit investments had to be replaced by investment control and high taxes. Low cost of debt and high tax revenues would also allow the expansion of government activities in the economy.⁵⁴

It seems likely, then, that the main driver of the shift was pragmatic rather than ideological. Indeed, many of the changes that occurred in Sweden also occurred in non-Social Democratic countries, the most notable being the USA. Indeed, the very use of the concept of “macroeconomic regime” implies a large cross-national convergence in policy that transcends the party adherence of national governments. A pragmatic change in the face of events—albeit it can be argued that these events were misinterpreted—thus explains a great deal of the establishment of the new regime. Ideology and theory were nonetheless important to provide a cognitive framework and legitimacy of the policy shift.

It is important to distinguish between two forms of pressure derived from pragmatic considerations. First, there was a gradually evolving regulatory ambition that started in the beginning of the twentieth century.

This amounted to a tentative experimentation with constraints and regulations of the banking sector in an otherwise liberal economic order. The failure of financial markets in 1929, the subsequent depression, and the Kreuger crisis led to more regulation. Economic planning during World War II, the increased ambition of the Social Democrats toward the end of the war, and the increased dominance of Keynesian theories did not initiate this process. The motivation for the low interest rate, however, was very different from that behind the regulatory movement to stabilize the banking sector: one grew out of a series of recurring crises; the other grew out of large government debt and the perceived need to stimulate the economy in order to ensure full employment.

In any case, the ideology of the Social Democrats, the experiences of government wartime planning, and the academic revolution of Keynesianism were very much compatible with the pragmatically derived policies. It is highly probable that the entrenchment of these policies was due to the convergence of pragmatism, theory, and ideology.

For central bank officials, the new developments were seen as a disaster. Whereas the gold standard had legitimized considerable central bank independence, the end of the war saw a sharp reduction of that independence as central banks became subjugated to the roles of ensuring that large government debts could be managed and preventing a postwar recession. The international cooperative organization for central banks, the Bank for International Settlements (BIS), argued constantly against the low interest rate policy and referred to the fear of postwar depression as “something of a psychosis.”⁵⁵

In 1945, there was a widespread fear that inflation would strike the Swedish economy and cause an increase in interest rates. An important part of the Social Democratic policy was therefore to push back against inflation tendencies. The national debt had increased considerably during the war, with the banks being the major buyers of government bonds. With the end of the war, there was an important shift in the banks' capital management from bonds toward lending. One effect of this shift was an increase in the number of treasury securities on the Swedish market, which compelled the state, i.e., the Riksbank, to buy

securities to prevent interest rates from rising. The Riksbank was thus faced with the task of halting inflation without being allowed to raise interest rates. Consequently, the Riksbank contacted actors in the financial market to persuade them—through informal agreements—to limit their lending and issuing of bonds. Even industrial companies that were dependent on the issuance of bonds for their own financing were contacted by the Riksbank in an effort to persuade them to refrain from issuing new bonds.

This policy was introduced by the government, but the Riksbank—which was responsible for its execution—was reluctant. Ivar Rooth, who had found little reason to question the Social Democratic government in the 1930s and during the war, now found his beliefs increasingly challenged by the new government policies. Consistent with the prewar mindset, he thought that the only way to reduce lending in the financial system was for the Riksbank to stop purchasing treasury securities and allow the interest rate to increase. This policy was supported by the banks and other financial actors. On several occasions during the time period 1947–1948, this topic came up for discussion in Parliament, where the Social Democrats protected their policy from attacks leveled by the more right-wing parties. In its economic declaration after the parliamentary election in 1948, the Social Democratic government made it clear that the low interest rate and restrictive lending policies would prevail.⁵⁶

The worst problem, in Rooth's mind, was that in order to keep interest rates low, the central bank had to print money and use it to buy government bonds. This was, in essence, financing government debt and stimulating the economy with the printing press, a severe breach of established central bank wisdom. Rooth was concerned by the inflationary effects of this and tried unsuccessfully to persuade the government to let the central bank raise interest rates. The new policies and the traditional view on proper monetary policy could no longer be reconciled. After a final attempt to persuade the board of the Riksbank to change their policy, Ivar Rooth handed in his resignation.⁵⁷ He said, "I cannot participate in the central bank policy that is about to be inaugurated."⁵⁸ The stage was set for the next phase of the development of the Swedish financial system.

Notes

1. Larsson, *Staten och kapitalet*; Jonung, “Swedish Experience Under the Classical Gold Standard”.
2. Larsson, “State and the Financial System”, 170–172.
3. Larsson, “State and the Financial System”, 172–173. Previously, when commercial banks had the right to issue notes, the banks owned the notes and were liable on an “all for one and one for all” basis.
4. Sjölander, *Den naturliga ordningen*.
5. Larsson, *Staten och kapitalet*.
6. Larsson, *Staten och kapitalet*.
7. Bloomfield, *Monetary Policy Under the International Gold Standard* (1959); Capie, *Future of Central Banking*.
8. Capie, *Future of Central Banking*.
9. Newman, *Socialism*, 47.
10. SOU 1927:11, 44.
11. Quoted in SOU 1927:11, 43–44.
12. SOU 1927:11, 108; Larsson, *Staten och kapitalet*.
13. Keynes, *Tract on Monetary Reform*, 172.
14. Jonung, “Swedish Experience Under the Classical Gold Standard”, 361; Magnusson, *Sveriges ekonomiska historia*, 194.
15. Eichengreen, *Golden Fetters*.
16. Magnusson, *Sveriges ekonomiska historia*.
17. Lewin, *Planhushållningsdebatten*, 25.
18. Berggren, “Bertil Ohlin”, 533.
19. Erlander, *Tage Erlander, 1901–1939*, 177–178.
20. Kreuger, Sten. 2007. “Fraud and financial innovation: The match king.” *The Economist*. <http://www.economist.com/node/10278667>. Accessed on April 23 2017.
21. Wigforss, *Kreugerkris*.
22. SOU 1932:30.
23. Larsson, *Staten och kapitalet*, 100.
24. Jonung, “Riksbankens politik 1945–1990”, 349.
25. Berg and Jonung, “Pioneering Price Level Targeting”; Magnusson, *Economic History of Sweden*, 195; Rooth, *Ivar Rooth*, 68.
26. Hammar skjöld, “Centralbankerna i nutidens ekonomiska liv”; Söderberg, *Constructing Invisible Hands*.
27. Taylor, *English History*, 297.

28. Boverket, *Bostadspolitiken*, 42–44; Myrdal and Myrdal, *Kris i befolkningsfrågan*.
29. Magnusson, *An Economic History of Sweden*, p. 195.
30. “Kungl. Maj:ts proposition nr 318”, 49.
31. “Kungl. Maj:ts proposition nr 318”, 52.
32. “Kungl. Maj:ts proposition nr 318”, 52.
33. SOU 1941:18, 180.
34. Söderberg, *Constructing Invisible Hands*.
35. SOU 1941:18, 180; SOU 1942:25, 194; SOU 1944:11.
36. Quoted in SOU 1944:11, 210.
37. *Arbetarrörelsens efterkrigsprogram*, 3.
38. *Arbetarrörelsens efterkrigsprogram*, 5.
39. Kindleberger, *Keynesianism vs. Monetarism*.
40. *Arbetarrörelsens efterkrigsprogram*, 6.
41. *Arbetarrörelsens efterkrigsprogram*, 7.
42. SOU 1942:25, 17–418.
43. *Arbetarrörelsens efterkrigsprogram*, 8.
44. *Arbetarrörelsens efterkrigsprogram*, 80.
45. *Arbetarrörelsens efterkrigsprogram*, 83.
46. Sejersted, *Age of Social Democracy*; Heckscher, *Ödeläggelsen av 1800-talets hushållning*; Lewin, *Planhushållningsdebatten*.
47. Skildelsky, *John Maynard Keynes*, 15.
48. Kenen, “Bretton Woods System”.
49. Ahlström and Carlson, “Hammarskjöld, Sverige och Bretton Woods”; Magnusson, *Sveriges ekonomiska historia*, 202.
50. The Riksbank archive, Lemne (1991a), Ansvaret för penningvärdet, Riksbankschefers arkiv.
51. The Riksbank archive, Lemne (1991b), Obligationskän, Riksbankschefers arkiv.
52. Friedman, *Program for Monetary Stability*, 1.
53. Friedman, *Program for Monetary Stability*, 1–2.
54. Myrdal, *Varning för fredsoptimism*.
55. BIS, *Annual Report 1951*, 251.
56. Rooth, *Ivar Rooth*.
57. Rooth, *Ivar Rooth*; Jonung, “Riksbankens politik 1945–1990”, 296.
58. Rooth, *Ivar Rooth*, appendix 1.

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3

The Introduction of the Riksbank Regulation: 1950–1955

Abstract This chapter discusses the introduction of a new financial regulatory regime in Sweden based on regulations managed by the Swedish central bank, the Riksbank. This chapter analyzes the political background and the game played by the Ministry of Finance, the central bank, and the banks, and how the regulations were created through these negotiations. The analysis contains a detailed discussion concerning the creation of the new regulatory regime and also addresses the important question: should we view the regulations as being forced on the banks from above, or as a process in which special interests were able to capture the regulatory apparatus for their own benefit?

Keywords The Riksbank · Riksbank regulation · Banks · Insurance companies · Social Democracy

In this chapter, we closely follow the initiation of the new Swedish financial regulatory measures in the first half of the 1950s. The political discussion and the creation of the Riksbank measures influenced all actors in the market. Although the banks played the major role in

the credit market, managing the insurance companies was critical to total control of the financial system and to avoid loopholes that could undermine the regulatory system. We therefore also discuss the role of insurance companies and compare their development with that of the banks in the construction of the Riksbank regulation.

The Political Background

The previous chapter described how the Social Democrats came into power in the 1930s and how their priorities came to dominate economic policy and the long-term goals for societal development. This dominance meant that the government took direct control of the Riksbank in an unprecedented way. Social Democratic monetary policy during the 1950s was guided by three basic principles: to avoid the erosion of the Swedish currency, to keep interest rates low, and to allocate capital to prioritized sectors of the economy. This policy had been established during World War II and had proved to function well, but the situation in the early postwar period was quite different from that of the war years.

Ivar Rooth was succeeded by his deputy governor, Klas Bööök, who stayed as governor for three years. During the spring of 1950, Mats Lemne, who was the Secretary of State (i.e., second-in-command) at the Ministry of Finance, was appointed Deputy Governor of the Riksbank. Lemne was only 31 years old and relatively unknown in the banking industry. However, he was considered very competent after a swift rise through the government bureaucracy. Lemne's appointment also increased the contact between the government and the Riksbank and built the foundation for a larger degree of political control over the Riksbank in the future.

For a short period in 1949–1950, Mats Lemne was also the chairman of the board of *Stadshypotekskassan*, a state-owned mortgage bank for urban housing. In this capacity, he was, together with *Stadshypotekskassan's* CEO, responsible for negotiations with the Riksbank about a more restrictive credit policy to control inflation in 1950. The management and board of *Stadshypotekskassan* saw the advantage of having Mats Lemne in a central position in the company and therefore offered him the CEO

position, which he had to decline because he had accepted the position of Deputy Governor of the Riksbank.¹

The introduction of the regulations was connected to the international scene. In 1950, the Korean War broke out. The war boosted industrial production in the USA. This, together with the reduction in raw material exports from South and East Asia, led to inflationary pressure in the USA.² Because of the central role of the USA in the world economy, inflation spread internationally, which created a dilemma for the low interest rate policy: inflation needed to be curbed, but the interest rate could not be raised further. Riksbank's Governor Böök had already been allowed to implement a small interest rate increase in 1949, but further interest rate hikes were out of the question. Since the interest rate could not be used to reduce lending, the government decided that other tools were needed to reduce inflation.

There was a clear division between the Social Democrats and the liberal and conservative parties in Sweden with respect to the guidance of the capital market. For the Social Democrats, a restrictive policy for actors in the financial market was required for the long-term development of the Swedish welfare state. Economic growth was necessary for investments in new housing and other infrastructure investments. However, since Swedish industry showed considerable profit and could benefit from investments in the rebuilding of Europe after the destruction of World War II, growth was quite extensive.

The Introduction of New Regulatory Measures

With this backdrop as the point of departure, in August 1951, Deputy Governor of the Riksbank Mats Lemne issued a memorandum regarding the future policy of the Riksbank, which included a regulation that would give the Riksbank a mandate to implement regulatory measures concerning interest rates based on the economic situation and the government's priorities.³ Mats Lemne's previous employment in the Ministry of Finance had created close connections with the Social Democratic government and other politicians from the Social

Table 3.1 Riksbank regulatory measures introduced in 1951–1962

1951	Regulation of interest rates
1952	Liquidity quotas
1952	Control of new bond issues
1952	Cash quotas
1952	Punitive rate on loans from the Riksbank
1955	Lending ceilings for banks
1962	Investment quotas for insurance companies

Sources Jonung, "Riksbankens politik 1945–1990," 297; *Sveriges Riksbank, årsbok 1952, 1955*

Democratic inner circle, which became an important factor in the politicization of the Riksbank policy.

The Riksbank's interventionist policy was not only an important part of official monetary policy but also, according to Social Democratic policy, an increasingly important means of slowing the growing extension of credit to non-prioritized sectors of the economy. Available borrowing capital was supposed to be used primarily for the development of hydroelectric power plants, the restructuring and modernization of the Swedish agricultural sector, and, in particular, the construction of new dwellings in urban areas (because the population was expected to grow in expanding towns and cities). Free competition in the credit market would cause interest rates to rise, which in turn would harm prioritized areas, such as housing. Thus, to guarantee capital for the prioritized sectors at an acceptable interest rate, it was—according to the Social Democratic government—necessary to manage the business of both banks and insurance companies more closely than before.⁴ In essence, the market mechanism of investment was replaced by a social program of investment shaped by the overarching priorities of the government.

The first measure introduced by the Riksbank was the regulation of interest rates for both savings and lending. This regulation established a fluctuation gap for interest rates between maximum and minimum levels, which were connected to the discount rate. This new regulation placed the levels and size of this gap under the control of the Riksbank (Table 3.1). Thus, the discount rate was still important because it was used to regulate interest rates.⁵ The Riksbank's political power increased considerably with the introduction of this regulation.

During the 1950s, several new regulatory measures were initially presented as voluntary. However, given its strong negotiating position, the Riksbank could—as discussed later—essentially force actors in the market to adhere to the regulation, especially by threatening to introduce laws instead. The most important measure was the liquidity quotas introduced in 1952, which made it possible for the Riksbank to direct banks' use of capital liquidity. These liquidity quotas were defined as the ratio between a bank's deposits and its liquid assets. Liquid assets included government bonds and bonds issued by mortgage banks. In practice, if the liquidity quota was, for instance, 40%, the bank's loans could not exceed 60% of total deposits during a specific period. The Riksbank could thus quickly restrict the availability of capital on the market by adjusting the liquidity quotas.⁶

In the same year, the Riksbank introduced special controls over bond issuance, including a requirement that all new bond issues had to be approved by the Riksbank. These controls made it possible to direct new issues to prioritized economic sectors and to regulate their interest rates and sizes. The restrictions on bond issues were critical to ensuring that the restrictions on bank lending were not circumvented by the issuance of more bonds, which would increase inflationary pressure.⁷

The banks' businesses were also affected by special cash quotas introduced in 1952. These quotas imposed special requirements on the amount of cash capital that should be directly available from the banks upon demand from the Riksbank. If the bank could not meet this demand, it had to borrow money from the Riksbank at a punitive rate. Thus, the banks were incentivized to use incoming deposits to increase their cash quotas, which in turn had an immediate effect on the availability of capital in the credit market and could therefore be used for emergency measures, for example, when the economy was overheated.⁸ After a lengthy discussion in the Swedish parliament, these suggested restrictions were approved and were implemented beginning in 1952.

Beginning in 1955, banks' lending was also limited by a lending ceiling, which was intended to place an absolute restriction on banks' credit extension. When these restrictions were in place, only a certain percentage of the increase in deposits during a single year could be used for

new credit. This regulation had a hampering effect, particularly on the extension of credit to individuals.⁹

A similar regulatory scheme was also applied to insurance companies beginning in 1962 when special investment quotas were introduced. This restriction had previously been designed as a voluntary agreement between the insurance companies and the Riksbank, which meant that new negotiations had to be conducted and new agreements reached nearly every year. However, beginning in 1962, the Riksbank could change these quotas without the consent of the insurance companies. According to these rules, insurance companies were required to reserve a certain portion of their annual premium income for the financing of new dwellings and the purchase of state bonds.¹⁰

The introduction of these regulatory measurements laid the foundation for a new regulatory regime in the Swedish financial market. This coincided with the introduction of new rules in other Western European countries as well. For example, similar rules were introduced in both Norway and Finland. Their motive was the same as Sweden's: to ensure that capital for prioritized areas would be available. Unlike France, for example, where state-owned credit institutes were used to direct capital flows, Sweden maintained a market structure with private actors. Nonetheless, the Riksbank's regulatory measures reduced competition and created the opportunity for agreements with private actors to complement the regulations, as discussed later.

The introduction of this new regulatory regime was not without problems or disputes between actors in the financial market and the Riksbank. Later in this chapter, we highlight the most important events in the introduction of the new regulatory regime, especially the difference in the handling of these regulations between insurance companies and banks. Initial developments during the introduction of the Riksbank regulation were of fundamental importance for the functioning of the Swedish financial market over the following three decades. Once the new regulatory regime had been accepted, minor changes in policy could easily be introduced, whereas larger changes were more difficult because the various parts of the regulatory system were closely connected and dependent on one another.

Banking and Insurance: Political Questions

The Riksbank's measures for the banking and insurance markets had their foundation in ongoing contact between the Riksbank and private companies during World War II. The role of the Riksbank in the financial market had changed by the time the war ended, particularly with respect to the purchase of bonds on the open market. These purchases had become necessary after the extensive realization of war bonds, which banks and insurance companies started immediately after the war in 1945. To establish this policy, the Riksbank governor held recurring discussions on the development of interest rates and changes in the bond market with representatives of banks and insurance companies. Through these contacts, the Riksbank obtained valuable information about the development of the financial market and changes that might come in the future. This knowledge helped the Riksbank to outline a policy that could make it possible to reach the goals established by the government.

The Riksbank also had more direct contacts—especially with insurance companies—during the late 1940s. As the Riksbank tried to slow inflation in 1948, discussions were held with both banks and insurance companies about reducing the supply of capital. In May 1948, the head of the Swedish insurance inspection board, Olof André Åkesson, was asked to act as a mediator between the government and the Riksbank on one side and the insurance industry on the other. The goal was to induce the insurance sector to reduce its sale of bonds on the open market. However, neither the Minister of Finance nor the governor of the Riksbank wanted to approach insurance companies directly. It was deemed better for Åkesson, who was held in great esteem in the insurance industry, to make these contacts and thereby show support for governmental policy. After initial contacts with the CEOs of several of the larger life insurance companies, Åkesson managed to persuade them to sign a letter of intent stating that the companies would not reduce their holdings in state bonds and bonds from mortgage institutes during the following six months. However, because this agreement reduced potential profit for the insurance companies by restricting investment in

assets more profitable than low interest-rate bonds, the insurance companies were strongly opposed.¹¹ The mediation by Åkesson was probably the determining factor in persuading the insurance companies to accept these restrictions even though they conflicted with profit maximization. Several actors in the financial market greatly mistrusted the Social Democratic economic policy and harbored a particular distrust of Minister of Finance Ernst Wigforss.¹²

The Negotiations Between the Riksbank and the Banks

The agreement between the insurance companies and the Riksbank was not renewed. Instead, in December 1951, the governor of the Riksbank, Mats Lemne, initiated discussions with a group of representatives from the financial market, selected from among Lemne's personal contacts. The group was named "The Quinque" ("The Five"). In addition to Lemne, The Five included representatives from two commercial banks (*Handelsbanken* and *Göteborgs Bank*), a mortgage institute (*Hypoteksbanken*) that specialized in the agricultural sector, and an insurance company (the life insurance company *Thule*). Other representatives from the Riksbank could also be called to these meetings.¹³ The original idea for the meetings with these representatives came from Lemne's predecessor, but as Deputy Governor of the Riksbank, Lemne had contacts with industry insiders and saw the potential to obtain information from the market in an informal way. The meetings were held in secret, which was probably a prerequisite for a candid discussion of development of the financial market. The secrecy also helped group members to preserve the market's trust in their respective institutions. These discussions probably helped Lemne to understand both the practical functioning of the financial market and the reactions of banks and insurance companies to measures implemented by the Riksbank.

Thus, development of the Swedish financial sector in the late 1940s and early 1950s was characterized by extensive interaction between

political and private actors. Banks and insurance companies were not only important for solving acute economic problems faced by the government—for example, ensuring a market for government bonds—but also instrumental in the long-term development of the Swedish economy and in the fulfillment of the government's economic priorities, for example, the financing of new housing construction, the restructuring of the agricultural sector, and the expansion of power generation. Therefore, although the Riksbank was formally autonomous, in practice it was subordinate to the Ministry of Finance. The leadership role of the Ministry of Finance was guaranteed by personal relationships with the Governor of the Riksbank. In this regard, Governor Mats Lemne was an ideal choice because he had previously been employed by the Ministry of Finance.

The contacts between the Riksbank and actors in the financial market became more formal with the introduction of the Riksbank regulatory measures starting in 1952. In particular, the introduction of liquidity quotas demanded more frequent contacts between the Riksbank and the banks. The commercial banks reported their liquidity situation to the Riksbank each month, and a couple of days later they met to discuss the situation. Some participants in the informal meetings of the Five also attended these monthly meetings. Similar contacts were arranged for savings banks; based on their reports, they met every second month. The Riksbank and the insurance companies initially met only every third month, when the insurance companies sent their reports to the Riksbank. However, monthly meetings were eventually introduced for insurance companies as well. In addition to these scheduled meetings, the parties met on special occasions, such as when changes were made to the discount rate or the liquidity quotas. On these occasions, the Riksbank met first with the commercial banks and thereafter with the other financial actors.¹⁴ This sequence reflected the importance of commercial banks with respect not only to the economy at large but also to successful implementation of the Riksbank regulatory policy.

The Collaborative Banks

When the Riksbank regulation was introduced, the commercial banks reacted with caution. There was no organized opposition to the new regulatory regime from the banks; rather, they agreed on the importance of restricting bank lending because of the increased risk of inflation, especially during the Korea boom in 1950–1951. In 1950, inflation reached 1.2%; in 1951, it increased sharply, to 15.6%. Inflationary pressure was the main motivation for both the government and the Riksbank to introduce regulatory measures expeditiously. It was probably apparent to the banks that some sort of restriction would be effectuated to restrain inflation. The restrictions suggested by the Riksbank were therefore met with a certain understanding. Moreover, when the monthly meetings between the Riksbank and the banks commenced in 1952, the banks agreed on the need to restrict lending. The more restrictive policy proved to be effective: by 1952, inflation was down to 7.9% and the following year it was 1.3%.¹⁵

A restrictive credit policy had been an important component of government policy in the late 1940s and was necessary to keep inflation in check while maintaining low interest rates. However, when Mats Lemne became Governor of the Riksbank, both the macroeconomic situation and the general economic policy had changed. The Riksbank's position vis-a-vis their contacts at the commercial banks had also changed, as Parliament had given the Riksbank the right to decide whether to implement the new regulatory measures. Therefore, even though the commercial banks were basically averse to these new regulations, it might have seemed meaningless to protest. Instead, the commercial banks adopted a pragmatic approach toward the Riksbank policy, especially during its early years, when the threat of overheating and inflation was dire. Therefore, in the negotiations between the Riksbank and the banks, the Riksbank had a strong position and could use a mixture of coercion and incentives to implement its policy. The threat of far-reaching legislation to replace voluntary agreements was always present, as were promises of milder regulation in the near future if the banks showed they could function appropriately. Nonetheless, the official basis

for the policy was still voluntary agreements with the banks achieved through negotiations.

The introduction of the Riksbank regulation began with Mats Lemne inviting the board of the Swedish Bankers' Association (the industry organization for commercial banks) to discuss the new measures. With the Bankers' Association as its counterpart, the Riksbank could directly reach all banks at the same time. This relationship strengthened the role of the Bankers' Association in the financial market. The CEO of *Handelsbanken*, Ernfrid Browaldh, was also the chairman of the Bankers' Association. His pragmatic attitude toward the new Riksbank regulation probably facilitated the introduction of liquidity quotas. Even during discussions with the banks in which the Riksbank did not participate—i.e., when there was no need for lip service—he advocated a pragmatic approach to the regulations. Browaldh was probably very aware of the strong position of the Riksbank and tried to obtain the best result for the banks he represented. Nonetheless, although the banks might have at times implemented a similar policy in the absence of the Riksbank regulation, there were critics of the policy, for example, with respect to the introduction of liquidity quotas and of new bonds.¹⁶

A typical meeting between the Riksbank and the banks began with a review of the current credit and monetary policy situation. Then, Riksbank representatives commented on the extent to which the banking sector and specific individual banks had fulfilled the different requirements set forth by the Riksbank. After this opening, the governor of the Riksbank presented specific arrangements for regulating credit and maintaining the low interest rate policy. The flow of information between the Riksbank and commercial banks was quite open during Mats Lemne's term as Governor of the Riksbank, even though it was obvious that Lemne had the final say.

The liquidity quotas of 1952 were accepted by banks, as was the restriction on the issuance of new bonds. This agreement was renewed in 1953, but when it was up for discussion again in 1954, there was some disagreement. The Riksbank wanted to extend the previous agreement, which was acceptable to the Bankers' Association; however, when the Association was asked to recommend that its members sign the agreement, the Wallenberg-owned *SEB* refused.¹⁷ The problem was not

the content of the agreement or the difficulty of meeting the liquidity quotas but rather that the agreement was presented as a recommendation and not an agreement. *SEB* was of the opinion that an agreement implied a subjugated position for the banks vis-a-vis the Riksbank. However, after several changes to the document, the agreement was signed by *SEB*, and thus this event serves mainly as an example of the power struggle between the Riksbank and the banks.¹⁸ During the conflict between *SEB* and the Riksbank, it became obvious that the Riksbank would consider imposing stricter restrictions on the banks if they did not sign the agreement. In the spring of 1954, the cash-reserves requirement was increased; during the following decade, changes to the Riksbank regulation became more frequent.¹⁹

There was no open opposition to the Riksbank regulation during the first half of the 1950s. By contrast, the internal discussions held by the banks indicate a strong resolve to adhere to the agreements. To fulfill the regulatory requirements, voluntary groups were organized among the banks to analyze the Riksbank requirements and discuss the implementation of new rules. One important example of this cooperation was the special banking group dedicated to interest rates, in which only a few commercial banks were not represented.

There was considerable confusion regarding the interest rate policy, which could be described as a signaling game between the Riksbank and the banks. In October 1954, a new state bond issue was introduced at a 4% interest rate—a 1% increase in the official interest rate, a change that was welcomed by the banks. At the same time, however, the banks were disappointed that the Riksbank failed to fulfill its monetary policy by neglecting to change the discount rate. This was a clear relaxation of the Riksbank policy. However, no detailed information was forthcoming on how interest rates should be handled in the rest of the financial market; instead, Mats Lemne emphasized the role of market-adjusted interest rates—i.e., rates adjusted by the banks themselves, as opposed to being based on the discount rate. He stressed that the use of the discount rate as an instrument to adjust interest rates was obsolete and that it was for this reason that the discount rate had been left unchanged.²⁰

Because the Riksbank had previously combined changes to the official bond rate with changes to the discount rate, Lemne's statement

prompted a debate about the official policy, especially among banks. Since the financial market had been awaiting and advocating higher interest rates for several years, one might expect that the banks would quickly take advantage of this opportunity, but there was clearly a fear among the banks of doing something that the Riksbank did not expect or want. The banks wondered whether this development was really a change in official policy or merely a test of their loyalty to the Riksbank. This matter was discussed in meetings among the banks for well over a month. In particular, Marcus Wallenberg of *SEB* warned against taking advantage of the situation, whereas another large bank, *Handelsbanken*, was more supportive of raising interest rates for both savings and lending. However, the Bankers' Association advised that all members agree on a unified resolution so that all banks could jointly publish the new interest rates in the daily newspapers.²¹

The banks ultimately decided to increase interest rates on both deposits and lending by half a percent. This move was criticized by Mats Lemne for the lack of diversification, both between the banks and between different types of accounts. Lemne's complaint was that the banks that had failed to meet the liquidity quotas should not have the same ability as other banks to increase interest rates on deposits. As the discussion continued, the banks agreed to leave depositary interest rates more or less unchanged but to increase interest rates on lending, with the exception of lending to the housing sector. These changes were totally in line with the Riksbank policy and allowed the banks to earn higher incomes, which would make it easier to meet liquidity quotas. Another advantage for the Riksbank was that the decision to adjust interest rates was made by the banks and not by the Riksbank, which may have made the restriction easier to accept.

The discussion about interest rates illustrates the signaling game between the Riksbank and the banks during the 1950s. The banks held regular meetings to discuss problems in the financial market, with the interpretation of the Riksbank policy as the most important subject. Thus, the Riksbank policy encouraged cooperation among the banks and thus promoted cartelization of the banking sector both directly (through rules) and indirectly. Competition on the lending side was also reduced because opportunities to recruit new customers were hindered

by the Riksbank lending restrictions. Restrictions on interest rates also limited competition in the savings market. However, since there was a substantial need for capital, the banks were forced to attract depositors by other means, such as personal service and an increased number of branches. Thus, the banks benefited from the Riksbank regulation because it restricted competition and stabilized the economic situation. This benefit compensated for the limitation of possibilities to increase lending and may be one reason that the banks accepted the Riksbank regulation.

The Intransigent Insurance Industry

The introduction of the Riksbank regulations to the insurance market was much more complicated compared with the banking market because the insurance industry displayed more direct and principled opposition to the new measurements. Insurance companies had protested increased government intervention into the insurance market in the late 1940s. In particular, the large life insurance company *Thule* objected to the restriction on selling government bonds on the open market because it would reduce the companies' profits (other investments were more profitable) and disadvantage policyholders, which was incongruent with insurance legislation.

This disagreement was brought out into the open when the Riksbank invited the insurance companies to negotiate the new regulatory measures in 1952. Both *Thule* and the cooperative insurance company *Folksam* rejected all regulations that limited the insurance companies' investments, whereas other insurance companies were more amenable. However, Mats Lemne wanted to avoid separating the insurance companies into different interest groups, with some companies following the new regulation while others did not.

As he had in the banking industry, Lemne contacted the appropriate trade association, which in this case was the Swedish Insurers' Association, and asked it to recommend to its members that they sanction the Riksbank regulations. The chairman of the Association, conservative politician Kurt Everlöf, accepted this request, and the

recommendation was approved by all member companies. Considering the previous criticism from some of the companies, this might seem surprising, but since it was formulated as a recommendation, not a binding agreement, all the companies could accept it. However, if the recommendation was carried out, it would lead to extensive control over the insurance companies. The companies would be obligated to adopt the interest rates set by the Riksbank and could not independently expand their credit. This regulation was originally intended to remain in force until the end of June 1952 but was extended to the end of the year.²²

The contacts between the Riksbank and the insurance companies resumed in September 1952 for the purpose of reaching a new voluntary agreement for 1953. This time, however, it was much more difficult to bring the parties together. Mats Lemne asserted that the insurance companies had not acted as expected and that the insurance industry was more divided and less cooperative compared with the banks. One reason for the difference was that the Insurers' Association had a relatively weak position in the industry compared with the Bankers' Association. Specifically, large segments of the insurance industry were organized into specialized associations (for example, for fire insurance, life insurance, or break-in insurance) and direct cartel agreements.²³ A large number of associations made it difficult for the Riksbank to conduct a formal discussion and the negotiations were discontinued. Instead, Mats Lemne unilaterally proposed legislation, and by October the government announced that it was willing to support this legislation.²⁴

This development opened the door to new discussions between the Riksbank and the insurance companies, this time with the added support of the Swedish Social Democratic Prime Minister Tage Erlander, who participated in one meeting. At the same time, the proposal for compulsory legislation was rapidly pushed through by the government, which increased the pressure.

The discussion within and between the insurance companies rapidly intensified. The large life insurance company *De Förenade-Framtiden* rejected the idea of an agreement with the Riksbank; *Skandia* was also averse to the idea. However, the final decision of *Skandia* depended on the attitude of two larger banks. The chairman of *Skandia*, who was also

chairman of the second largest Swedish bank, *Skandinaviska Banken*, was against an agreement with the Riksbank. By contrast, the vice chairman of *Skandia*, Jacob Wallenberg, from *SEB*, said that he would vote with the majority of the board. Ernfrid Browaldh, the chairman of the largest Swedish bank, *Handelsbanken*, which was also represented on the board of *Skandia*, was more amenable to the Riksbank suggestion and started working toward a compromise.

At a meeting between the Riksbank, the banks and the insurance companies at the end of October 1952, Browaldh presented his compromise. The assets of insurance companies would be divided into (1) prioritized assets, comprising state and mortgage bonds, and (2) unprioritized assets, including loans to industry and shares. The insurance companies' annual investments would be allocated between these two groups. This proposal was applauded by the Riksbank, and new negotiations with insurance companies were initiated. Despite internal disagreements, the board of the Insurers' Association agreed to reject the compulsory legislation and instead opted for a limitation of credit to industry. However, four insurance companies chose to remain outside this discussion: two life insurance companies, including the large company *De Förenade-Framtiden*, and two non-life insurers.²⁵

With minor changes, the Browaldh suggestion was presented as the Riksbank proposal. At the same time, the legislative proposal was withdrawn. This proposition was directly accepted by 78 insurance companies, whereas three companies initially hesitated to sign the agreement and four companies decided not to support it.²⁶ This agreement became the regulatory framework for all insurance companies and was maintained as the basis of the Riksbank policy until the 1980s. This process can be seen as a clear example of how the Riksbank used its power to force insurance companies to accept a "voluntary" agreement by threatening to enact legislation otherwise.

The Browaldh compromise demonstrates the important role of individuals in strategic positions in developing the Riksbank regulation. It opened the door to discussions between the Riksbank and the insurance companies. Regarding Browaldh's motives for playing this role for the government, it is likely that he believed that the Riksbank regulation was necessary to create stability in the financial market, regardless of his

personal view of the law. An agreement between the Riksbank and both banks and insurance companies was also necessary to maintain neutrality in competition between the different credit institutions. As chairman of the Bankers' Association and a board member of *Skandia*, Browaldh could understand this need early in the process. To preserve the banks' ability to compete in the credit market, it was critical that similar regulations be implemented for both banks and insurance companies. However, a compulsory regulation for the insurance industry would not only limit the companies' potential for development but also encourage a similar regulation for the banking industry, which was definitely not in the banks' interest.

The Introduction of the Riksbank Regulation: Conclusions

The introduction of the Riksbank regulation was closely connected to Mats Lemne as a person. During his employment at the Ministry of Finance, Lemne had been in close contact with the Social Democratic Party and was familiar with its political goals. His experiences were important not only for the implementation of the Riksbank regulation but also for political control of the Riksbank. His position as the Riksbank Governor gave him authority in the development of the regulation, and he cultivated close relationships with representatives of the banks and the Bankers' Association. Lemne's closest contact was probably the CEO of *Handelsbanken*, Ernfrid Browaldh. Browaldh's position as chairman of the Bankers' Association gave him unique opportunities to influence the composition of the Riksbank regulation, which was apparent in the formulation of regulations for insurance companies.

Mats Lemne's relationships with the CEOs of the two other largest banks—*SEB* and *Skandinaviska Banken*—was more problematic because these banks were less pragmatic about the Riksbank regulation compared with the *Handelsbanken*. Another obstacle for Lemne as Riksbank Governor was his relative youth. As mentioned above, when he assumed his position he was only 31 years old and a relatively

unknown player in the banking sector. Several bankers with whom Lemne negotiated had held leading positions in their respective banks before he was even born. It was likely difficult for these powerful men to accept such a young man as the overseer of their activities.

In hindsight, it might seem surprising that the Riksbank regulation was relatively easily accepted, especially by the banks, because it was an extensive intrusion into the free development of banking. However, negotiations started during the Korea boom, when the banks and the Riksbank had a mutual interest in halting inflation. Given the circumstances, the banks could accept at least some temporary restrictions on credit extension. Additionally, it is unlikely that long-term use of the Riksbank regulation was anticipated in the early 1950s. Otherwise, the protests would probably have been much more extensive. In other words, the banks did not know what they were signing up for.

Another effect of the Riksbank regulation on both insurance companies and banks was reduced competition. Competition in the insurance market had been hindered since the interwar period by the extensive use of cartel agreements. The addition of the Riksbank regulation to the limitations on establishing new insurance companies—which were implemented in the insurance legislation of 1948—further contributed to the cartelization of the insurance industry.²⁷

Cooperative agreements had also been established in the banking market since the interwar period, especially regarding interest rate levels.²⁸ The Riksbank regulation led to increased communications among banks and thus reduced competition even further, at least in certain areas of the banking industry. Although it was difficult to compete on interest rates to attract new borrowers, competition in the deposits market remained intense. Competition occurred primarily through the establishment of offices in new areas and based on the quality of service. There were also advertising campaigns to attract customers from competing banks, which was a source of constant quarreling between the banks.

Mats Lemne remained as head of the Riksbank until spring 1955, for a total term of only 4 years. During these 4 years, however, Riksbank policy for the coming 35 years was designed and tested. Contacts between the Riksbank, banks, and insurance companies focused on the development and functioning of regulatory measures, as well as on the intentions and consequences of these measures.

In a broader context, the establishment of the Riksbank regulation can be viewed as an example of the cooperation that distinguishes the so-called Swedish model: agreement and collaboration between the government and business. Thus, it entailed negotiations between representatives of banks, insurance companies, and the state, which was a common feature of development during the 1950s and 1960s, the golden age of the Swedish model. However, it is important to remember that these negotiations were dominated by the Riksbank and the government, and coercion was used more frequently than incentives during the establishment of the Riksbank regulation. The relationship between the Riksbank and the government was very close, which made it possible for the Riksbank to use the threat of legislation to impose the regulations through agreements with banks and insurance companies. It is more difficult to identify the incentives, although promises were made of “lighter” regulations in the future if the “tough” regulations were accepted now, at least for the banks. In conclusion, despite the dampening effect of the regulations on competition, the dominant role of the Riksbank, which was supported by the government, makes it difficult to interpret the regulations as a form of “regulatory capture” in which market agents were able to create regulations solely for their own benefit.

Notes

1. The Stadhypotek Archive, Protokoll fört vid styrelsens för Konungariket Sveriges stadhypotekskassa sammanträden den 18 november 1948. 21 Juni 1949, 27 oktober 1949.
2. Radetzki, “Anatomy of Three Commodity Booms”, 58.
3. Jonung, “Riksbankens politik 1945–1990”, 297.
4. SOU 1949:13.
5. Erlander, *Tage Erlander 1949–1954*, 34–35.
6. *Sveriges Riksbank årsbok 1953*.
7. *Sveriges Riksbank årsbok 1953*.
8. *Sveriges Riksbank årsbok 1952*.
9. *Sveriges Riksbank årsbok 1955*.
10. Nygren, *Från Stockholms Banco Till Citbank*, 83–85.

11. According to the legislation governing insurance companies, beginning in 1948, insurance companies were required to manage policyholders' capital in the most advantageous manner possible—i.e., obtaining the highest rate of interest. Several insurance companies argued that satisfying this requirement would be impossible if they accepted the Riksbank regulation regarding low interest-rate bonds. See Fredrikson et al., *Framtiden minnesskrift*.
12. The Riksbank Archive, överenskommelser med försäkringsbolagen 1948–1955; Brev från Sveriges Riksbank till Svenska Försäkringsbolags Riksförbund. Riksbankschefens arkiv.
13. The Riksbank Archive, Riksbankschefens Archive.
14. The Riksbank Archive, Carl-Göran Lemnes Archive; Jonung, “Riksbankens politik 1945–1990”, 339–344.
15. SOS, “Levnadskostnadsindex”.
16. Jonung, “Riksbankens politik 1945–1990”, 323–328, 341–345.
17. The Wallenberg family was the majority owner of Stockholms Enskilda Bank (SEB) and a major player in Swedish industry since the late nineteenth century.
18. Olsson, *Bank, familj och företagande*, 85–87.
19. Olsson, *Bank, familj och företagande*, 88.
20. Handelsbanken Archive, Tore Browaldh, Noteringar angående ränteförändringen, 16 oktober 1954.
21. Handelsbanken Archive, Sammanträde med ränteavtalsbankerna den 20 oktober, 25 oktober, 29 oktober, 30 oktober 1954.
22. The Riksbank Archive, Brev från Sveriges Riksbank till Svenska Försäkringsbolags Riksförbund F1A vol 162 A. Riksbankschefernas arkiv.
23. Larsson and Lönnborg, *Kundägda svenska försäkringsbolag*.
24. The Riksbank Archive, Överenskommelse med försäkringsbolag 1948–1955, F1A vol 162 A, Riksbankschefernas arkiv.
25. Fredrikson et al., *Framtiden minnesskrift*, pp. 235–236, 299. The Riksbank Archive, Överenskommelse med försäkringsbolag 1948–1955, F1A vol 162 A. Riksbankschefernas arkiv.
26. Fredrikson et al., *Framtiden minnesskrift*, pp. 235–236, 299. The Riksbank Archive, Överenskommelse med försäkringsbolag 1948–1955, F1A vol 162 A. Riksbankschefernas arkiv, Before the Riksbanken proposal had been presented, the planned legislation was less far-reaching. Nevertheless, the insurance companies entered into an agreement with the Riksbank that might have been the result of a general fear of legislative measures, which in the long run could result in stronger public control.

27. Larssonand Lönnborg, *Kundägda svenska försäkringsbolag*.
28. Carlsson, *Skandinaviska Banken i näringsliv och samhälle 1939–1971*.

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4

Tensions Mount in the Statist Regime: 1955–1960

Abstract This chapter focuses on the interaction between the economic development of the period and the regulatory setting. It opens up with the internationalization of central banking and the end of the interest rate policy, and then follows up with the increased tension between the banks and the central bank.

Keywords Riksbank · Banking regulations · Sweden · Social democracy

The period between 1955 and 1968 began with an international movement to return central banks to the prominent position they had held in the prewar era. This movement also inspired the Swedish Riksbank under Governor Per Åsbrink, which represented a clear challenge to the Social Democratic postwar program. Nevertheless, the Riksbank under Åsbrink continued to enforce the regulations. However, new developments gradually established a clear dialectic relationship between the evolution of the economic system—both internationally and

domestically—and regulatory changes to facilitate the adjustment of the banking sector to these evolutionary developments.

The Internationalization of Central Banking and the End of the Low Interest Rate Policy

After a meteoric career, Mats Lemne resigned from his position as Governor in 1955 and never returned to Swedish high politics. Thus, it was necessary to appoint a new Riksbank governor. This decision had clear political implications. The Social Democrats wanted someone who would represent the party inside the central bank, whereas the opposition, spearheaded by the leader of the Liberal party (*Folkpartiet*) and economist Bertil Ohlin, wanted a more politically neutral governor—specifically, the economist Ingvar Svennilson.¹ The position of Riksbank governor was not very attractive to aspiring younger members of the Social Democratic elite because of its low level of independence from the government and the lack of prestige associated with central banking in the postwar era. One candidate turned down the offer because, as Prime Minister Erlander wrote in his diary, he “felt that the policy of the Riksbank must be subjugated to the government, which means that the governor of the Bank has a rather dull task.”² Erlander’s right-hand man, Per-Edvin Sköld, agreed with this but said that one could do what Lemne had done during his term as governor: “intuitively foresee the government’s policy and implement it in advance and thus be independent in front of oneself and others.”³

The position was finally offered to and accepted by Per Åsbrink. Åsbrink had been a rising member of the Social Democratic Party; previously, he had taken part in several government commissions and had been the editor of the party journal, *Tiden* (“*The Time*”). In hindsight, Åsbrink appears to have been more of a careerist than a devoted follower of the party’s agenda, viewing the political ascendancy of the Social Democrats as a ladder for his own career. In any case, his background as a Social Democrat made it necessary for Erlander to push through his appointment. According to Sköld, Åsbrink explicitly accepted that his role as governor was to ensure implementation of the party’s policies.⁴

The development of Åsbrink as a central banker took an unexpected turn, however. He became increasingly enmeshed in the international network of central banks built around the Bank for International Settlements (BIS). This development posed a challenge to the politicization of the Riksbank that had begun in the 1940s. Soon after Åsbrink's appointment, he received letters from both Per Jacobson, the Swedish head of the BIS research department and his predecessor, Ivar Rooth. Both were ardent critics of Social Democratic policies. They congratulated Åsbrink on his appointment and advised him to orient himself internationally. This was the beginning of strong relationships among Åsbrink, BIS, and other central bank governors who participated in the monthly meetings in Basel.⁵ During his first months in office, Åsbrink demonstrated his willingness to openly adopt an anti-inflationary stance. In a much-publicized event, he attacked the wage-setting process and warned of the dire consequences of inflation. He characterized the previous decade as “ten years of frivolity.”⁶

This bold move struck a chord with his peers in the international central banker community. The Governor of the Bank of England, Cameron Cobbold, wrote and congratulated Åsbrink on his “wise and forceful speech.”⁷ The head of the German central bank, Wilhelm Vocke, likewise extended his congratulations. The Bundesbank had an unusually high level of independence from the government as a result of occupation laws after the war and memories of hyperinflation in the 1920s.⁸ In his response, Åsbrink stated openly that he aspired to a similar position for the Riksbank in Sweden: “Allow me to say that I would like to hope that my work will have the same opportunity to influence domestic economic development that yours has, Mr. President.”⁹ That same year, Åsbrink was invited to become a member of the board of BIS, a position he was “not only prepared but also eager to take and learn from the work of the Board.”¹⁰

Internationally, the low interest rate policy came under pressure as central banks became more defiant against government policy. In the USA, the Federal Reserve defied the government on the low interest rate policy. The ensuing conflict received considerable media attention and ended with the Federal Reserve gaining substantial independence to raise interest rates. In Germany, as mentioned above, the central bank had substantial independence owing to the occupation laws of the

Allies. When Chancellor Konrad Adenauer failed to stop an interest rate increase in 1956, he initiated a public showdown with the central bank. The bank won over the media and caused Adenauer considerable political damage. This example served as a warning to future Chancellors who wanted to impinge on the independence of the German central bank.¹¹ Following such successes, the BIS Annual Report of 1956 could announce that “it is clear that the progressive return to flexible monetary policy has now brought to an end the era of rigid credit conditions which dated back to the depression of the 1930s.”¹²

The Riksbank was allowed to raise the discount rate by 1% in 1955. Then, in 1957, Åsbrink persuaded the Board of the Riksbank to increase the interest rate by 1% without notifying the government.¹³ This so-called “interest rate coup” triggered a political crisis. Erlander wrote in his diary that the period after the coup marked “the darkest moments” of his career.¹⁴ Retaliatory actions were deemed necessary, which risked depicting the party in an authoritarian light. The media had played an important role in similar conflicts in both the USA and Germany. Erlander noted in his diary that Åsbrink was unlikely to step down without a fight in which he would “ruthlessly attack” the government.¹⁵

The coup launched an extensive debate in Swedish media about the proper role of the central bank.¹⁶ Åsbrink was allowed to remain, however. As in the USA, the advantage gained by the central bank as a result of the interest rate struggle was a new understanding between it and the government rather than full independence. Erlander had a meeting with Åsbrink on November 1957 in which “conditions for cooperation” were established.¹⁷ The government was to have the decisive role, whereas the governor had to use the threat of resignation and the power of his arguments to influence policy. Nonetheless, the interest rate was not lowered and Åsbrink kept his post despite openly defying government policy.

Banks Versus The Central Bank

Even though he had defied the government on the low interest rate policy, Åsbrink continued to enforce the Riksbank regulation. Since he had not worked on banking issues in his previous positions, the first

years were a learning period. The Riksbank's contacts with banks and insurance companies were well established, so he inherited a functioning system. The monthly meetings with banks and eventually insurance companies were maintained, albeit with a slightly different setup.

The meetings, usually held on a Wednesday in the middle of the month, commenced before lunch with a preparatory meeting for the banks in connection with the Bankers' Association board meeting. At approximately 3 p.m., bank representatives gathered at the Riksbank to meet with Riksbank management. Normally, the CEOs of all banks (except the smallest banks) participated, whereas each of the three largest banks—*Handelsbanken*, *SEB*, and *Skandinaviska Banken*—was represented by two people.¹⁸

The meetings began as they had during the Lemne years, with an analysis of the liquidity situation. In addition, as before, the major aim was to impose restrictions on the banks' lending. However, the meetings were less amicable than they were during the Lemne period. The meetings were often tense, which impeded creative discussion and problem solving. Lars-Erik Thunholm, head of *Skandinaviska Banken*, claims in his memoir that the main problem was Åsbrink's authoritarian style and lack of knowledge about banking, which made it difficult for the bank representatives and Åsbrink to communicate.¹⁹ Although this description of Åsbrink's personality is consistent with other accounts,²⁰ there were probably additional reasons for the mounting tensions. The sense of urgency related to the Korean War, which had served as an important motivation for the banks to accept the regulations, was no longer a factor. Moreover, as argued in the previous chapter, the banks had accepted the regulations because they assumed that they were temporary. As the years passed without an end to the regulations in sight, the bankers likely grew frustrated. The process of regulation itself was cumbersome, entailing weekly meetings of top officials. This format was a relic of the voluntary regulatory system during wartime when there was a sense of united purpose and continual meetings were deemed appropriate. It required substantial effort by both the banks and the central bank to continuously implement the regulations, which likely added to frustrations on both sides.

When the regulations were introduced, liquidity quotas were a highly contested topic at meetings between the Riksbank and the banks. As the banks gradually adjusted to the liquidity quotas, discussions about them decreased. The quota levels were also stable for several years, which gave them the appearance of permanent fixtures in the business landscape. However, since the liquidity quotas were deemed to have had little effect, the lending ceiling was introduced in 1955 as a more direct restraint on the banks' lending (see Chap. 3). As a result, the banks were forced to sharply reduce their lending. For the largest banks, this regulation implied a 6% reduction of credit in 1956. The banks reluctantly adhered to the lending ceiling by reducing credit limits and demanding higher amortization of loans to industrial customers. These actions generated increased tension because the meetings were soon dominated by discussions about whether the banks had extended too much credit. Thunholm gives several examples of the continual struggle between the banks and the Riksbank as well as of Åsbrink's aggressive scolding.²¹

The end of the 1950s also saw a careful move toward a more market-oriented approach to the financial system. For the banks, this shift came suddenly. At a meeting with commercial banks on June 19, 1957, Åsbrink condemned the banks for having increased their lending and coming too close to the lending ceiling, and he strongly urged them to be more restrictive. But only 4 weeks later, at the routine banking meeting, Åsbrink announced that he was inactivating the lending ceiling because the economy had moved into a recession. He warned, however, that if he perceived that this change was being abused and that the banks' extension of credit was growing too fast, the lending ceiling would be reactivated.²²

After the lending ceiling was inactivated, both liquidity quotas and interest rates were adjusted more frequently. Mats Lemne had abandoned the use of the discount rate as a means to regulate interest rates, but Åsbrink's scrapping of the low interest rate policy opened the door to a more flexible monetary policy. Several banks claimed that the changes caused their lending to decrease and halted investments in the agricultural sector, among other areas. However, these effects were only temporary and likely connected to the recession in 1957–1958.

When the lending ceiling was (temporarily) abandoned, the Riksbank reintroduced the use of liquidity quotas. The suggestion that

the quotas would be reviewed every month was not met with enthusiasm by the banks, probably because they expected that these reviews would result in higher quotas. However, because of the economic recession, the Riksbank refrained from increasing the quotas. In 1959, the minimum quotas were changed and diversified, with the highest quotas for the largest banks and the lowest quotas for the smallest banks. Beginning in 1960, the liquidity quotas were revised several times each year, which meant that the Riksbank became more active in both evaluating the Riksbank policy and criticizing the banks for not being responsible enough. The threat of harsher banking restrictions was always present.²³

In general, higher interest rates were also likely to increase opportunities to finance borrowing by the state and mortgage institutes in the market. Higher interest rates would also make it easier for banks to transfer loans for building activities to mortgage institutes. At the same time, the cost of borrowing would increase, which would affect state expenditure. For the banks and other credit institutes, higher interest rates would increase the potential to increase earnings.

In the 1960s, the discount rate was frequently used as a countercyclical means for stimulating the economy during economic recessions and as an austerity measure when the economy was overheating.²⁴ Increased interest rates also prompted a cautious opening of the bond market, particularly for mortgage institutes but eventually for other private investors as well. Notably, even when the tough restrictions of the 1950s were replaced with a more market-friendly policy in the 1960s, Åsbrink maintained an authoritarian posture toward the banks and insurance companies. However, the more flexible monetary policy enabled more lending by the banks. Nonetheless, the banks continued to cooperate on setting interest rates, which limited competition.

The meetings between the banks and the Riksbank also served as a forum for discussing more general economic problems in Sweden and internationally. It was not uncommon for the banks to use these meetings to criticize the underlying economic policy of the Riksbank regulation, which made it possible for the banks to criticize more general government policy, such as the economic policy of the Social Democratic government. For instance, at the Riksbank meeting in

December 1957, the chairman of the *Handelsbanken* board, Ernfrid Browaldh, said that he had been worried that his bank showed excess lending of 26 million *kronor*, but when he scrutinized the public budget for 1958, he noticed that welfare reforms would increase the state budget by 480 million *kronor* per year for the following 3 years. At the same time, both state taxes and working hours would be reduced, leading to a loss of production equal to 1.8 billion *kronor*. He concluded that the only area in which restrictions were a priority was the Riksbank policy.²⁵ Thus, discussions at the Riksbank meetings had evolved into general political discussions, and Per Åsbrink acted as a representative of the government.

The increase in state expenditure resulted in higher levels of borrowing in the bond market. Thunholm argued that this trend could transform the banks into a place for the “collection” of government bonds, which clearly would reduce opportunities to finance building activities and industrial development.²⁶ This policy was defended by the Governor of the Riksbank, who emphasized the difficulty of placing these loans on the market without the help of banks and insurance companies.²⁷

Basically, Per Åsbrink and the banks agreed that the problems with the Swedish economy lay in the macroeconomic financial policy and not the monetary and credit policy. Therefore, the problems could not be solved through contacts between the Riksbank and the banks and insurance companies.

Notes

1. Erlander, *Dagböcker 1957*, 60–61.
2. Erlander, *Dagböcker 1957*, 16.
3. Erlander, *Dagböcker 1957*.
4. Erlander, *Dagböcker 1957*, 125.
5. The Riksbank Archive. Rooth to Åsbrink April 3 1955, Jacobsson to Åsbrink April 18 1955, Personal Correspondence of Per Åsbrink 1955–1956. Rooth, *Ivar Rooth, riksbankschef*, p. 57.

6. “Åsbrink till attack”.
7. The Riksbank Archive, Cobbold to Åsbrink November 8 1955, Personal Correspondence of Per Åsbrink 1955–1956.
8. Deutsche Bundesbank, *Fifty Years of the Mark*.
9. The Riksbank Archive, Letter from Per Åsbrink to Wilhelm Vocke, Personal Correspondence of Per Åsbrink 1955–1956.
10. The Riksbank Archive, Letter from Per Åsbrink to Maurice Frère, Personal Correspondence of Per Åsbrink 1955–1956.
11. Deutsche Bundesbank, *Fifty Years of the Mark*, 291; Sproule, “The Accord”; Meltzer, 699–712.
12. BIS, *Annual Report 1956*, 166.
13. Carlson, *Enprocentiga revolutionen*.
14. Erlander, *Dagböcker 1957*, 126.
15. Erlander, *Dagböcker 1957*, 124.
16. Carlson, *Enprocentiga revolutionen*.
17. Erlander, *Dagböcker 1957*, 224.
18. Jonung, “Riksbankens politik 1945–1990”, 344.
19. Thunholm *Flydda tider*.
20. Offer and Söderberg, *Nobel Factor*.
21. Thunholm, *Flydda tider*.
22. The Swedish Bankers Association archive, Strömbergs anteckningar från sammanträde med Riksbanken den 19 juni 1957 Strömbergs anteckningar från sammanträde med riksbanken den 11 juli 1957 med anledning av diskontohöjningen.
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26. The Swedish Bankers Association Archive, Strömbergs anteckningar från sammanträde med riksbanken den 12 januari 1958.
27. The Swedish Bankers Association Archive, Strömbergs anteckningar från sammanträde med riksbanken den 25 februari 1958.

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5

International Turmoil and Regulatory Changes: 1960–1979

Abstract This chapter concerns regulatory changes in Sweden and internationally during the 1960s and 1970s. Domestically, a number of factors gradually changed the banking landscape which meant that adjustments to the regulatory post-World War II framework. The use of the Riksbank regulatory measures was increasingly adjusted to macro-economic changes and stability problems, instead of political priorities. Internationally, the crumbling of the Bretton Woods and the oil crisis of the 1970s are the main topics covered. This set the stage for dramatic changes for the Swedish banking sector, as in other countries.

Keywords Sweden · Riksbank · Banking regulations · Savings banks · Eurodollar

Toward the second half of the 1960s, Swedish financial regulations were subject to increasing pressure from both national and international developments. Nationally, a series of incremental changes in the regulatory system was caused by deeper changes in social structure. Continual urbanization and industrialization, the development of a full consumer society and maturation of the welfare state all converged into constant

pressure on the regulatory structure. Internationally, the Bretton Woods system established after World War II was starting to crumble, which led to increased international financial fluctuations and strained the Swedish financial system.

The Transformation of the Savings Banks

A major change in Swedish banking was the transformation of decentralized savings and agricultural banks into large scale, for-profit banking. Today, the descendant of these networks of small regional banks, *Swedbank*, is an international concern with branches in Luxemburg, Shanghai, and New York, among other places.¹ This development flourished in the decades after World War II. Continuing urbanization and a decline in the percentage of the population employed in agriculture dampened future prospects for small regional savings and agricultural banks. Other developments likely further weakened their prospects. For example, the emergence of a consumer society led to increased demand for short-term credit and more flexibility in transactions. The development of the welfare state—part of the package that included the banking regulations—also reduced the need for long-term savings for old age and to buffer adverse life events.

The traditional division of the banking market, in which savings banks primarily catered to long-term savings of individuals, agricultural banks served smaller farmers, and commercial banks tended to business enterprises, was encoded in the banking regulations.² In the 1950s, concerns had been raised that the regulations impaired the ability of savings and agricultural banks to compete with the commercial banks for market share. A number of minor legislative changes were implemented to expand the areas of activity for savings and agricultural banks in order to facilitate increased competition with commercial banks. Limits on the amount of money that could be deposited at savings banks were raised. The membership requirement that limited the use of agricultural banks was relaxed. In 1955, savings banks were allowed to offer their customers transaction accounts and to issue credit on transactions through these accounts.³ This decision was made despite the warning by a government committee that transaction accounts would undermine the essence of savings

banks—i.e., saving for long-term purposes—in favor of short-term consumption transactions.⁴

The developments related to savings and agricultural banks led to a dismantling of the formal differences between the different types of banks in 1968. A government commission stated in its 1967 report that shifts in social developments had undermined the traditional divisions among the different banks. Different types of banks now largely offered the same services to their customers. Hence, the committee argued that a uniform regulatory system that covered all types of banks would encourage competition. In contrast to the mentality behind the Social Democratic postwar program and the regulatory system of the time, the committee stressed the benefits of competition. Specifically, competition would allow banks to “more flexibly adapt to the shifting credit needs of society” and encourage them to conduct “cost-cutting rationalizations” while preventing them from overextending themselves in a socially inefficient manner.⁵ In this regard, the spirit underlying the regulations had clearly changed from the one that dominated at the end of the war.

However, traditional differences and the continued impact of the Riksbank regulations prevented the legislated uniformity from having any significant effect.⁶

Housing Construction and the “Million Program”

As early as the 1950s, the huge investments needed to sustain construction of housing and to extend infrastructure to all regions of a rapidly growing country led to problems in ensuring financing. Even larger investments were expected to be necessary in the future. Minister of Finance Gunnar Sträng commissioned a government investigation in 1957, explaining that the future credit market had to be “well adapted to the demands of development.” The investigation resulted in the credit policy legislation of 1962, which comprised three separate laws that allowed the Riksbank to impose three forms of credit policy regulation: imposition of capital and liquidity quotas, establishment of credit placement quotas for prioritized projects, and interest rate caps. However, the investigation cautioned that interest rate caps were an “extreme” measure that would tend to distort the credit market and

open the door to lending outside the traditional bank sector. The law on interest rate caps was also the only one that was never used.⁷ Notably, the law did not include the imposition of lending ceilings on banks; nonetheless, lending ceilings were imposed on banks in the late 1960s, as discussed later.

In December 1959, the government created a commission to look at the housing situation and propose remedies for the future. In 1965, the commission delivered its report, which spawned the formation of a massive construction campaign to “build away” the remaining housing shortfall. The campaign was dubbed “the Million Program” because of its stated ambition to build 1 million apartments between 1965 and 1974. That goal was in fact surpassed, leading vacant apartments by the end of the 1960s. Long-term contracts in the construction sector, however, made it difficult to reduce construction.⁸ The Million Program placed increased pressure on the credit system because the Riksbank had to ensure that sufficient credit was allocated to housing construction, which fed into the process of change already underway.

The Crumbling of Bretton Woods and the Rise of the Eurodollar

As mentioned in the early chapters, Sweden’s economic policy was heavily constrained by international events during the first half of the twentieth century. This constraint arguably was exacerbated during the second half of the century. The increased internationalization of central banking, with BIS serving as its hub, was described above. To fully understand the constraints facing the Riksbank and the Swedish government during the period covered by this chapter, it is necessary to provide an overview of the developments that undermined not only the Bretton Woods system but also national postwar credit policies.

There were three main sources of pressure against the postwar credit edifice.⁹ The first was the increasing difficulty of ensuring adequate currency reserves to cover the national balance of payment deficits.

The second was the problems faced by national governments when the Bretton Woods framework required the imposition of austerity measures. The third was increased capital mobility and the rise of the Eurodollar market, which threatened to undermine national regulations.

Bretton Woods allowed adjustments in exchange rates between countries but only under extraordinary circumstances. National prestige thus became an issue because using currency devaluation as a means to boost exports to obtain more foreign currency was seen as a sign that a country had mismanaged its economic policies.¹⁰ Furthermore, revaluation was opposed by many interest groups in different countries because of the fear that it would damage their competitiveness in the global market.¹¹ The resulting inflexibility in exchange rates meant that a balance of payments deficit had to be adjusted primarily by sharply reducing demand, which required both austerity in public finances and constraining private demand by raising taxes or interest rates. Such measures were politically costly.

Although the USA had a modest trade balance surplus due to its continued superiority in productivity and the benefits of the dollar being the de facto world currency, dollars poured out of the country. The main reasons for this outflow were military spending overseas and private direct investments as American firms expanded internationally.¹² The amount of dollars circulating outside the USA and the continuing outflow were bolstered by the birth of the Eurodollar market. Gary Burn defined the Eurodollar market as “the unofficial, unregulated and unrestricted international money market, dealing in ex-patriate dollar deposits held in a very liquid, short-term form, in *parallel* to the official, regulated and restrictive market.”¹³ Today, we would call the Eurodollar market a clear example of shadow banking. In the 1960s, shadow banking not only facilitated American direct investments but also increased speculative capital movements, which placed increasing pressure on national exchange rates.¹⁴ The Eurodollar market effectively undermined postwar regulations on capital flow and set into motion a trend that would eventually lead to a system of deregulated global capital movements.¹⁵

Taming the Beast: The 1969 “Kill Switch”

Efforts by the Riksbank to curb mounting losses in its currency reserves at the end of the 1960s by raising interest rates and clamping down on bank lending became known as the “Kill Switch.”¹⁶ As the name implies, this policy was heavily criticized and was cited as the reason for the Swedish economic recession in the early 1970s. However, it must be understood in the context of its time.

At the root of the set of events that prompted the Riksbank to initiate the Kill Switch was the imbalance in European trade structures. Several countries ran a trade deficit, whereas West Germany, having emerged in the postwar era as the economic powerhouse of Europe, had a large trade surplus. This led speculators to expect a devaluation of several key European currencies and a revaluation of the German mark. Pressures on West Germany to revalue its currency, however, were ignored.¹⁷

In late 1968, capital flight from France to Germany began because speculators expected the franc to devalue and the mark to revalue. The French President, Charles de Gaulle, vowed that the French franc would not be devalued; instead, France would undertake austerity measures, including government budget reductions and higher interest rates. The aim was to decrease France’s trade deficit by more than a billion US dollars in 1969.¹⁸

To make matters worse, American firms borrowed large sums of money in the Eurodollar market to finance the construction of subsidiaries in Europe. As mentioned above, this was a component of the huge overseas investments made by American firms in the 1950s and 1960s. Furthermore, American banks took short-term loans in Eurodollars in order to meet the monthly reserve requirements of American regulations,¹⁹ which in turn drove up interest rates on the Eurodollar market. Thus, it became attractive for speculators to move funds out of regulated national financial systems and into the unregulated Eurodollar market.

In early 1969, pressure was also mounting on the Swedish krona. As mentioned earlier, currency regulations were in place that in theory

should have stopped currency outflows. However, there were exceptions to currency regulations for financing Swedish investments overseas and export credit. These exceptions became “leaks” in the Swedish financial system.²⁰ The expectation of a German appreciation caused Swedish firms to either quickly sell their kronor for marks or to hold on to their marks. Deposits in Swedish banks were withdrawn, but demand for lending increased. This led banks to increase their reliance on loans from the Riksbank.²¹ As mentioned above, currency devaluation was seen as a sign of mismanagement by a country’s monetary and financial authorities, and Åsbrink was not willing to accept such humiliation. At a meeting of the Board of the Riksbank on February 27, Åsbrink expressed an intent to raise the discount rate in order to rein in banks’ use of central bank loans. He explained that the present situation was caused primarily by speculation against the French franc and attempts to fend this off, as well as increased borrowing by American banks in the Eurodollar market. An increase in the interest should therefore be seen as an alignment of the Swedish interest rate with interest rates on the Eurodollar market. Furthermore, the Swedish banks had been “less than willing” to accommodate the recommendations of the Riksbank regarding liquidity levels.²² The Board therefore made the decision to raise the discount rate by 1% and to invoke liquidity quota regulations to ensure that the banks adhered to the quotas established by the central bank.

This series of events did not improve the situation. De Gaulle resigned after losing a referendum. Suggestions by German policymakers that Germany might be willing to revalue its currency fueled further speculation. In July, the French government initiated severe austerity measures and stopped all public investment. The American Federal Reserve made a failed attempt to hinder the flow of Eurodollars between US banks and their foreign branches by imposing reserve requirements on the loans between them. A firm commitment by the German government that the country would “never in eternity” revalue its currency likewise proved ineffective.²³

The outflow of Swedish currency also continued. At a Riksbank Board meeting on July 10, 1969, Åsbrink declared that the Riksbank had lost over 2 billion kronor, or one-third of its reserves, in the

previous year.²⁴ He continued to place the primary blame on the Eurodollar market but also increasingly blamed the Swedish banks, arguing that they were in effect financing the outflow of capital through their increased borrowing from the Riksbank. Based on his expectations of far more turbulence in the global economy, Åsbrink deemed it necessary to further increase interest rates as well as to further restrict lending by banks.

This clampdown was severely criticized from the outset, for example, by Erik Lundberg, one of Sweden's most prominent economists.²⁵ In his memoirs, Lars-Erik Thunholm, an executive at *Skandinaviska Enskilda Banken*, claimed that these policies completely incapacitated the Swedish credit market.²⁶ Other commentators placed the drastic measures in the context of a new world in which Sweden was frequently the victim of financial speculation. Even commentators not associated with the left described the Eurodollar market as “an incarnation of international speculation capital and the driving force behind the currency turbulence.”²⁷ Social Democratic economist Nils Kellgren questioned whether national central banks were still in control. He argued that the influence of the Eurodollar market was, in effect, “so strong that it cannot be controlled by any individual country....”²⁸

Regulatory Formalization

The Kill Switch increased the strain on the old arrangements between the banks, the Riksbank, and the government. According to Thunholm, the Kill Switch represented the peak of tensions between the banks and the Riksbank. Moreover, according to Thunholm, the Riksbank failed to perform its main function as the lender of last resort by restricting central bank lending in a time of liquidity problems. When Thunholm's bank exceeded its loan ceiling at the Riksbank, Åsbrink's punitive interest rates were implemented. Thunholm also claimed that a legal expert he retained to investigate the matter concluded that the Riksbank had exceeded its authority and could be sued. The threat of litigation was supposedly used to successfully “blackmail” Åsbrink into returning the money to the bank.²⁹ In addition, members of the Board of the

Riksbank were increasingly critical. For instance, at a meeting in March 1970, one member stated that discretionary decisions by the Riksbank regarding loan ceilings on different individual banks were problematic. Another member called for discussions to create a new system. Åsbrink promised to consider this proposal but emphasized that it would have to be implemented by an entity other than the Riksbank.³⁰ The Bankers' Association also demanded that an investigation into potential regulatory changes be conducted.³¹

The problem was that the legal framework was vague and needed clarification. In light of the seemingly permanent instability of the currency market, the temporary character of the regulations appeared to be at odds with reality. The general climate of cooperation between the banks and the Riksbank had also deteriorated, increasing the perceived need to ensure that it was legally permissible to force banks to implement policy if necessary. On June 30, 1971, Finance Minister Gunnar Sträng assigned staff at the Department of Finance the task of investigating credit policy regulations and developing proposals for change. He noted the demands by the Bankers' Association for an investigation into the regulations and cited "changes in the credit market" that had taken place since the regulations were created.³² Maintaining the construction of housing as a central priority, Sträng also touched on the deterioration of the climate of cooperation between the government and the banks, arguing that if an agreement with the banks on credit allocation to housing was not possible, then new rules should make it permissible to "force an arrangement" on the banks.³³

The End of Bretton Woods and the Åsbrink Era

Meanwhile, the developments that had placed a strain on the Bretton Woods system persisted. The continuing outflow of dollars and a deterioration of the American trade balance, exacerbated by the Vietnam War, led to pressure on the USA. The continual outflow of gold from the USA meant that the basic principle of Bretton Woods—that 35 US dollars could always be converted into an ounce of gold—had not been true for a long time.³⁴ On August 15, 1971, President Nixon

announced that the dollar was no longer convertible to gold. Although the Bretton Woods system was not formally abandoned, this announcement signaled its de facto end.³⁵ The destabilization of the dollar, the longtime anchor of the international economic system, set off a long, harrowing process among European countries to create a new reserve alternative that could solve the constant imbalances of payments between them. In the 1970s, European cooperation was mainly focused on the so-called “snake,” which allowed national currencies to fluctuate within a designated range (creating a snake-like movement). The snake was an ad hoc measure and was unable to provide a stable monetary framework. In addition, several countries, including Sweden, dropped out of the snake on occasion to stimulate exports by devaluing its currency outside the permissible range. The decade ended with the creation of the European Monetary System (EMS) and the European Currency Unit (ECU), which at that time was simply a basket of its constituent national currencies. This process would eventually lead to the creation of the Euro, which was accompanied by a new wave of problems.³⁶

In Sweden, Åsbrink oversaw Swedish currency maneuvers during the beginning of the 1970s. His long reign as governor of the Riksbank ended in 1973, just as real turbulence was setting in. It has been argued that the personality of the central bank governor has practical effects on how central banking is conducted.³⁷ However, the established personal relationships and informal compromises between long-term members of the government and a long-term central bank governor might be just as important. If so, the removal of such a long-term and authoritative governor as Åsbrink would indeed herald the end of an era and create a need to establish a new working relationship between the government and the central bank.

Åsbrink was replaced by Krister Wickman, who was as involved in the Social Democratic Party as Åsbrink had been when he was appointed in 1955, although Wickman was at a higher level in the hierarchy. He had not only been chairman of the Board of the Riksbank but also served as a Member of Parliament for the party and as a Minister of Industry and Minister of Foreign Relations for the government. However, Wickman’s close ties to the party led to his decision to resign after the historic defeat of the Social Democrats in 1976. Wickman was

replaced by Carl-Henrik Nordlander, who had previously been the head of the government-owned bank *Kreditbanken* until its merger with the Postal Savings bank (*Postbanken*) in 1974.

Judging by the personalities of the two Riksbank governors who succeeded Åsbrink, they might have been more flexible toward—or less able to prevent—the expansive government policies of the 1970s.³⁸ The turbulence of the 1960s and the beginning of the 1970s, caused primarily by imbalances of payments between surplus and deficit countries, intensified as several factors combined to create something similar to “a perfect storm,” to use the overused metaphor. Both monetary and real economic factors were significant. The cost of the Vietnam War and President Nixon’s successful application of pressure to the Federal Reserve to increase the money supply created global inflationary pressure.³⁹ Adding to this pressure, the prices of all major commodities increased sharply. Natural gas shortages in the USA caused prices of fertilizers in the world market to increase. Combined with a series of bad harvests in Asia and parts of Africa, these factors caused food prices to spike worldwide.⁴⁰

In 1973, the OPEC countries, dominated by Saudi Arabia, raised the price of oil as part of a campaign to exert political pressure on Western countries because of their support of Israel in the Yom Kippur war. Given the extensive role of oil in the industrial world, the sharp increase in oil prices led to increased inflationary pressure. Furthermore, increased competition from newly industrialized countries in Asia, especially Japan, had started to undermine the industrial basis of the post-war Western world, which placed additional pressure on the balance of payments. For Sweden, this meant that traditionally important industries, such as shipbuilding and steel, became increasingly unprofitable. Meanwhile, a resurgence of unrest in the labor market surprised politicians and economists alike. In Sweden, high global prices on lumber and ore led to large profits in the extraction industry. Together with expectations of high inflation, this eventually led, through negotiations, to large real wage increases.⁴¹ All of these factors contributed to severe inflationary pressure and unprecedented imbalances between countries as money poured toward the producers of commodities, especially

oil-exporting countries. The result was a combination of high unemployment and inflation, which was dubbed “stagflation.”

National responses to the 1970s crisis differed across countries. Some, including Germany, Japan, and the USA, deflated, making it a priority to bring down inflation. Others attempted to fight the recession. Swedish politicians had learned from the Kill Switch experience that restrictive measures were politically costly.⁴² Moreover, mainstream Swedish economists had been critical of the austerity of the Kill Switch and were now uniformly pressing for expansionary measures.⁴³ Sweden was thus one of the few industrialized countries to attempt to minimize unemployment through government support of the economy. By implementing the Bridging Policy (*Överbryggningspolitiken*)—so named because it aimed to create a bridge to the next forecasted international upward swing—the Swedish government went far beyond theoretical Keynesian demand stimulation. It engaged in a wide array of support programs, including direct subsidies to business enterprises and nationalization of crisis industries.⁴⁴

Another key feature was investments in export-oriented industries to obtain more foreign currency through increased exports. Riksbank governor, Krister Wickman, was a proponent of the Bridging Policy. The Riksbank thus willingly attempted to balance the conflicting demands of the old policy goals with the new goal of massively stimulating the economy. The Bridging Policy was not abandoned after the historic election defeat of the Social Democrats in 1976. Instead, it was pursued even more vigorously by the coalition of non-Social Democratic parties. Wickman’s successor, Nordlander, tried to persuade the government to abandon the policy but was unsuccessful.⁴⁵

The Law of Credit Policy Means

The investigation into credit policy regulation that started in 1971 was completed in 1974, the year after Åsbrink retired. Three factors explained the need for new legislation: (1) the goal to treat all types of banking uniformly, as previously codified in the regulatory changes of 1968; (2) the growing effects of international credit flows on the

Swedish economy; and (3) the increased ambition regarding housing construction related to the Million Program. The pressure on the last ambition worsened because of increased government borrowing to finance fiscal expansion in order to counter economic stagnation. All these factors indicated the need to “modernize” the credit legislation.⁴⁶ Increased flexibility and a reduction of legislative complexity were intended to increase the freedom of the Riksbank to choose how to address various situations. The temporary character of the regulations in the 1962 legislation was to be replaced with permanent arrangements. The discretionary use of lending ceilings on banks was to be codified in the law as well.⁴⁷ Finally, the three laws to cover different means of implementing credit policy were to be replaced by a single law that covered all of the identified means: liquidity quotas, mandatory investment quotas, and interest rate caps.

The Riksbank’s response to the proposed changes was positive. It asserted that the changes more or less codified methods already in use and urged swift enactment:

To manage the problems that characterize the present economic situation, a broad spectrum of credit policy means must be available, and the credit policy legislation proposed as a result of the investigation thus constitutes a major improvement. The current uncertainty, created not least by the international economic situation, makes it imperative that the proposed credit policy legislation is enacted without delay.⁴⁸

The 1974 Law of Credit Policy Means and the regulative measures enacted by the Riksbank in the second half of the 1970s can be interpreted as attempts to overcome the fundamental imbalances within international and national economic systems through tighter regulation. Indeed, it has been argued that the Swedish financial system was never more tightly regulated than in this period.⁴⁹ Similar proposals for solving the imbalances, for example, by increasing regulation of the Eurodollar market, were made within the international community. However, a growing faction favored deregulation to maintain balance. The choice increasingly seemed to be between increased regulation (the law of credit policy means and its sporadic application can be

interpreted in this light) and deregulation and the transfer of responsibility for managing the system to private banks.⁵⁰

The methods included in the new legislation were used extensively in the years that followed. Thunholm wrote in his memoir that hope among commercial banks that credit policy would ease up after Åsbrink's retirement was soon dispelled. The same could be said of hope that the new non-Social Democratic government would implement a more market-oriented, bank-friendly credit policy. Instead, the credit policy was tightened. In 1974, a series of interest rate increases was initiated to stave off currency outflow. Lending ceilings were also imposed, but restrictions on the amount of bank borrowing from the Riksbank were not. After the lending ceilings were removed in 1975, bank lending increased, prompting the Riksbank to take action in 1976.⁵¹ Liquidity quotas were increased, forcing banks to buy an unprecedentedly large amount of government bonds. Meanwhile, paradoxically, a deregulation process was initiated: to improve the Swedish balance of payments (at least in the short term), private loans for the purpose of industrial investments abroad were encouraged. Hence, regulations on foreign loans were eased.⁵²

The End of the 1970s

At first, the Bridging Policy was a success by all accounts. Unemployment was significantly lower than in other countries and industrial production was higher. However, during the second half of the 1970s, as the rest of the industrialized world improved their economic performance, Sweden's performance deteriorated. Sweden thus seemed to have established its own peculiar economic dynamic, one that was out of step with the international economy.⁵³

The Bridging Policy led to mounting government budget deficits (Fig. 5.1), which increased pressure to ensure financing for the massive Million Program building project.⁵⁴ Both Åsbrink and Sträng had effectively vetoed any attempts to borrow money abroad for government expenditure.⁵⁵ After Åsbrink's retirement, the Riksbank staff became more open to the prospect of taking loans from abroad. However, an

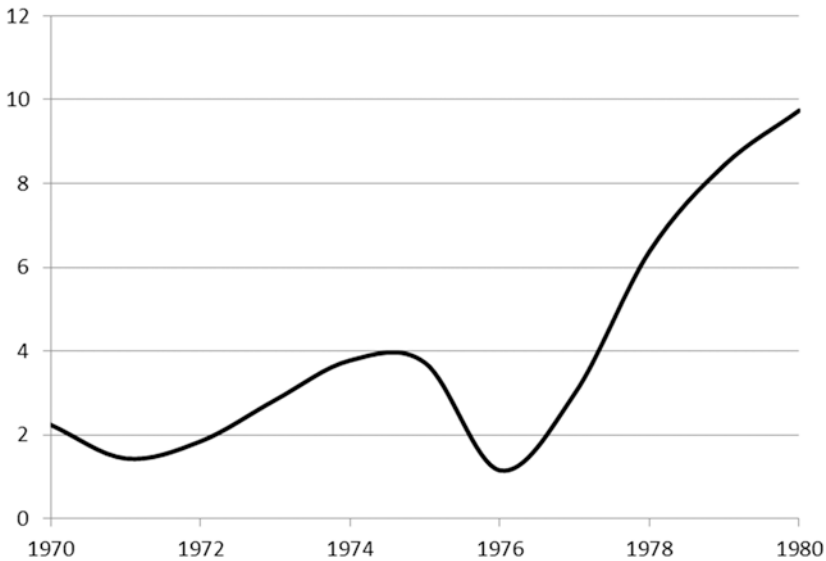


Fig. 5.1 Swedish government deficit as percent of national GDP, 1970–1980. *Source* Swedish Statistical Yearbooks 1970–1980

attempt to broker a loan with private banks in New York in 1974 was stopped by Sträng. Instead, the Riksbank itself acquired loans at BIS and the Iranian central bank. As noted above, private borrowing from abroad was encouraged in order to reverse capital flows. With Sträng retired and a new government in place, the final obstacle was removed and a working group was created to oversee the taking of government loans abroad. The Riksbank facilitated larger loans abroad beginning in 1977, and both the national debt and the debt held by foreign creditors increased (Fig. 5.2).⁵⁶

As the imbalances triggered a variety of ad hoc emergency measures, an ideological and theoretical shift was taking place. Simplified versions in which stagflation disproved the entire postwar Keynesian approach to the economy were likely too superficial (not least because, as noted above, few countries really embarked on policies akin to Keynesian stimulus). Nevertheless, governments could be credibly blamed for some causes of the imbalances of the 1970s, including the Vietnam War

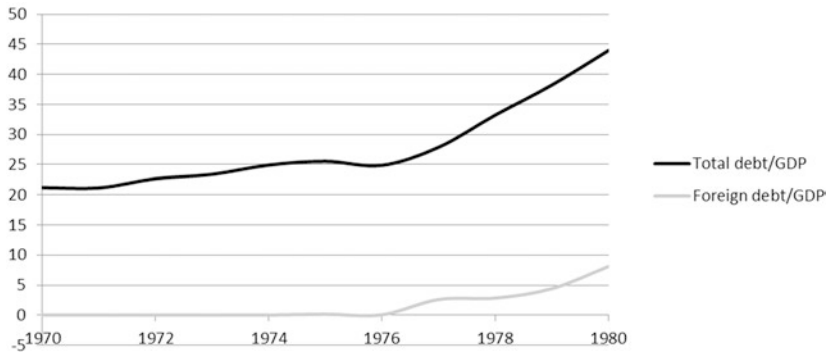


Fig. 5.2 Swedish total national debt in percent of GDP and national debt placed abroad, 1970–1980, as a percent of national GDP. *Source* Swedish statistical yearbooks 1970–1980, National debt by ownership

and Nixon’s political pressure on the Federal Reserve to ease monetary policy. A wide variety of business-sponsored think tanks intensified their activities, partly a defensive measure against the left-wing radicalism of the time. Within the community of international organizations, above all the IMF and the World Bank, the faction that advocated less regulation of international finance and increased reliance on private banks gained the upper hand.⁵⁷ Overall, regardless of whether it is called “the rise of neoliberalism” or “the fall of Keynesianism,” the belief that governments caused more problems than they solved gained credence in the imbalance-ridden world of the 1970s.⁵⁸ In the world of central banking, after the failure of the Federal Reserve to stand up to Nixon, a firmer stance on inflation became the international norm.⁵⁹

Consequences of the Statist Regime and the Riksbank Regulation

The aims of the Riksbank regulatory measures were initially to control inflation and to promote investments in prioritized sectors of the economy. To make the costs as low as possible, the low interest rate policy—which had been established during the interwar period—would

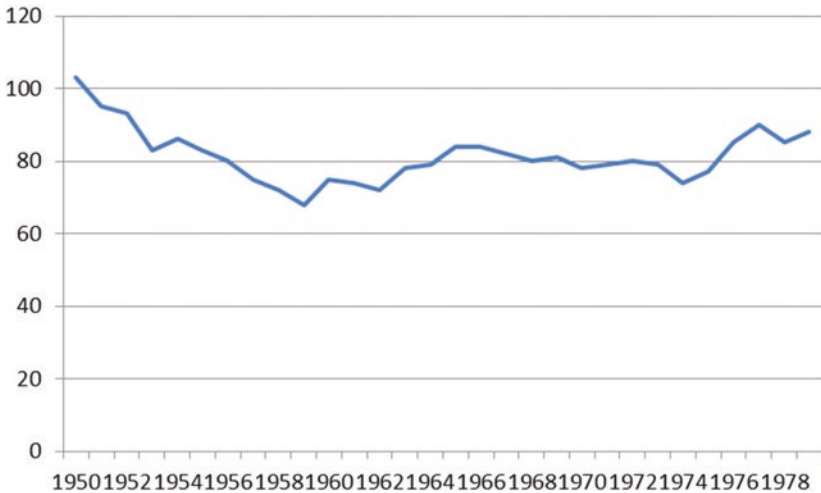


Fig. 5.3 Banks' total lending/deposit ratio for 1950–1979 (percent). *Sources* Sveriges Riksbank, annual reports 1950–1968, SOS, uppgifter om bankerna 1969–1979

be maintained. Fulfilling this policy required the introduction of new measurements, which was handled by the Riksbank. Consequently, the Riksbank became a direct extension of government policy and was directly controlled by political Social Democratic interests. This political governance was maintained for three decades despite a transition in political priorities toward a countercyclical economic policy with more market-oriented interest rates. Thus, the Riksbank regulation evolved into a convenient tool for the government to meet economic targets. However, in reality, what were its practical results?

One way to evaluate the results of this policy is to analyze changes in banks' lending. Liquidity quotas could be used to hamper lending on an annual basis. These quotas were initially relatively stable, which led to a stable decrease in the total lending/deposit ratio. However, compared to activity before the introduction of liquidity quotas, the reduction of the lending/deposit ratio was considerable during the 1950s (see Fig. 5.3). Although total lending exceeded total deposits in 1950, it was reduced to 70% of deposits during the last years of the 1950s, and for some

banks it was even lower. Undoubtedly, the policy initiated by Mats Lemne and upheld during the early years of the Åsbrink period had the anticipated effect and probably reduced inflation as well as lending.

Relief from the regulatory measures was also apparent in the 1960s, when the relative importance of lending increased. However, with the introduction of the Million Program to build new apartments in the mid-1960s, and particularly the implementation of the Kill Switch in 1968–1969, restrictions were tightened, although the effect was quite moderate compared to the 1950s. During the latter half of the 1970s, the banks' ability to increase lending improved. The economic recession during these years made investments important, and the strategic role of bank lending was recognized by both the government and the Riksbank. In hindsight, these were the first steps toward the deregulation of the Swedish financial market, which was implemented in the early 1980s and is the subject of the next chapter.

The investments of insurance companies were also heavily influenced by the Riksbank regulation. With the regulatory compromise between the Riksbank and the insurance companies negotiated by Ernfrid Browaldh, a stable system of prioritized and unprioritized investments was introduced that limited the annual investments of insurance companies in different areas. Since the investments of insurance companies were long-term, changes in their asset structures would be visible only after an extended period.

After the initial sale of war bonds in the late 1940s and early 1950s, the insurance companies' investments were subjugated to the Riksbank's priorities. Prioritized investments in government and mortgage institute bonds accounted for approximately 30% of insurance companies' total assets in 1950. Initially, this share did not increase, but beginning in the latter half of the 1950s prioritized investment increased in importance, growing to just over 33% in 1960 (see Table 5.1).

In the early 1960s, government bonds and debentures decreased in relative importance while bonds from mortgage institutes increased in importance as a consequence of the Million Program and the Kill Switch. In 1975, as much as 34.8% of insurance companies' assets consisted of mortgage institute bonds. Together with government bonds, prioritized investments accounted for over 46% of insurance companies'

Table 5.1 Total assets of Swedish insurance companies by investment type for 1950–1980 in percent of total assets

	Swedish government debentures and bonds	Mortgage institutes' bonds	Other bonds	Municipal loans	Loans against mortgage	Other assets
1950	17.3	13.4	13.0	4.0	25.8	26.5
1955	14.6	13.7	10.3	8.8	25.7	26.9
1960	16.1	17.1	9.0	9.3	32.9	15.6
1965	13.5	17.4	11.8	8.8	30.7	17.8
1970	10.2	27.7	17.8	7.1	15.7	21.5
1975	11.5	34.8	3.7	4.9	20.4	24.7
1980	17.2	30.5	3.9	4.4	14.5	29.5

Sources Compiled from Sveriges Riksbank, *Annual reports*

total assets. When the Million Program was completed in the late 1970s, investments in mortgage bonds decreased in relative importance, which created the opportunity for a broader investment strategy for insurance companies (see Table 5.1).

The significant increase in investments in prioritized assets since the mid-1960s reflects tight control over insurance companies' investments. This shift was made possible by a reduction in the relative importance of municipal and mortgage-backed loans. Although insurance companies' total assets increased from 33 billion *kronor* in 1970 to 103 billion *kronor* in 1979 (213%), the value of these loans increased by only approximately 80%.⁶⁰

This analysis of the economic development of banks and insurance companies provides evidence of the central role of the Riksbank regulation and shows that the government's efforts to promote investment in building activities and to finance the national debt was largely successful. However, this success meant that capital was withdrawn from other potential investments. On this ground, the Riksbank policy was criticized by both banks and industrial companies, and demand for credit increased among both businesses and individuals. Therefore, releasing the floodgates of credit was perceived by many as an attractive option as the 1980s began.

Notes

1. “Från sparbanker till Swedbank”. Swedbank. <https://www.swedbank.se/om-swedbank/fakta-om-swedbank/bankens-historia/fran-sparbanker-till-swedbank/index.htm>. Accessed on April 23 2017.
2. Larsson and Sjögren, *Vägen till och från bankkrisen*.
3. Larsson and Sjögren, *Vägen till och från bankkrisen*, 32–36.
4. SOU 1954:10, 158.
5. SOU 1967:64, 36–37.
6. Larsson and Sjögren, *Vägen till och från bankkrisen* 40.
7. SOU 1960:16, 11, 33; Ds 1974:2, 27, 61–87.
8. SOU 1965:32; Boverket, *Bostadspolitiken*, 54–57, 69.
9. This account draws on James, *International Monetary Cooperation Since Bretton Woods*.
10. Kenwood and Lougheed, *Internationella ekonomins tillväxt 1880–1990*, 305.
11. James, *International Monetary Cooperation Since Bretton Wood*, 112.
12. Eichengreen, *Global Imbalances and the Lessons of Bretton Woods*, 12–15.
13. Burn, *Re-Emergence of Global Finance*, 16.
14. James, *International Monetary Cooperation Since Bretton Wood*, 179–180.
15. Gilpin, *Global Political Economy*, 234; Altamura, *European Banks and the Rise of International Finance after Bretton Woods*.
16. The Swedish term *idiotstoppet* literally translates into “the idiot stop”.
17. James, *International Monetary Cooperation Since Bretton Wood*, 194.
18. James, *International Monetary Cooperation Since Bretton Wood*, 195.
19. Kellgren, “Europadollarn”.
20. Vikbladh, “Räntan och valutaregleringen”.
21. Thunholm, *Flydda tider*, 194.
22. The Riksbank Archive, Bankofullmäktige 27 februari 1969.
23. James, *International Monetary Cooperation Since Bretton Wood*, 196.
24. The Riksbank Archive, Bankofullmäktige 10 July 1969.
25. Lundberg, “Varför en så drastisk penningpolitik?”.
26. Thunholm, *Flydda tider*, 194–195.
27. Fahlström, “Spekulanterna”.
28. Kellgren, “Europadollarn”.
29. Thunholm, *Flydda tider*, 197.

30. Minutes, March 12 1970. Stockholm, The Riksbank Archive, Fullmäktiges särskilda protokoll 1969–1970, A1B:66.
31. Ds 1974:2, p. 29.
32. Ds 1974:2, p. 29.
33. Ds 1974:2, p. 30.
34. Eichengreen, *Global Imbalances and the Lessons of Bretton Woods*.
35. James, *International Monetary Cooperation Since Bretton Wood*, 219.
36. Wihlborg, “Valutapolitiken”; James, *International Monetary Cooperation Since Bretton Wood*; James, *Making the European Monetary Union*.
37. For a summary see Singleton, *Central Banking in the Twentieth Century*, 20–22.
38. Nordlander advocated austerity but failed to convince the government, see Wihlborg, “Valutapolitiken”, 229.
39. Irwin, *Alchemists*, 63–65.
40. James, *International Monetary Cooperation Since Bretton Wood*, 253; Radetzki, “Anatomy of Three Commodity Booms”.
41. Magnusson *Economic History of Sweden*, 260; Bohlin, *Swedish Industrial Policy*, 126, 128. Downey, *Oil 101*.
42. SOU 1999:150, 217.
43. For a discussion on the relationship between micro and macro thinking among Swedish economists, see Jonung, *Med backspegeln som kompass*, 170; Söderberg, *Constructing Invisible Hands*.
44. Jonung, *Med backspegeln som kompass*, 163–184; Magnusson, *Economic History of Sweden*, 258.
45. Wihlborg, “Valutapolitiken”, 229; Eklöf, *Tre valutakriser*, 28, 35.
46. Ds 1974: 2, p 116.
47. Ds 1974: 2, p 21, p 23.
48. The Riksbank Archive, Memo to Department of Finance 1974, Registratur 1972–1974. Stockholm.
49. Eklöf, *Tre valutakriser*, 50.
50. Altamura, *European Banks and the Rise of International Finance after Bretton Woods*, 121–132.
51. Thunholm, *Flydda tider*, 203–205; Eklöf, *Tre valutakriser*, 32.
52. Eklöf, *Tre valutakriser* 33; Jonung, “Riksbankens politik 1945–1990”, 331.
53. Jonung, *Med backspegeln som kompass*, 165; Magnusson, *Economic History of Sweden*, 261.
54. Ds 1974: 2, p.116.

55. Thunholm, *Flydda tider*, 203; Eklöf, *Tre valutakriser*, 45.
56. Wihlborg, “Valutapolitiken”, 228; Jonung, *Med backspegeln som kompass*, 167; Magnusson, *Economic History of Sweden*, 261; Eklöf, *Tre valutakriser*, 34.
57. Altamura, *European Banks and the Rise of International Finance after Bretton Woods*.
58. Backhouse, “Rise of Free Market Economics”; Offer and Söderberg, *Nobel Factor*.
59. Singleton, *Central Banking in the Twentieth Century*; Irwin, *Alchemists*.
60. Sveriges Riksbank, *Annual reports*.

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6

A New Regime Emerges: 1980–1995

Abstract This chapter discusses the deregulation of the Swedish financial market in the 1980s and the introduction of a new market-oriented financial regulatory regime. The driving forces of this regulatory change are analyzed, as well as its consequences in Sweden—a deep financial crisis in the early 1990s. The experience of this crisis is analyzed in detail, especially the Swedish way of handling it which has received large attention internationally.

Keywords Regime change · Deregulation · Market orientation · Internationalisation · Financial crises · Structural change

Background

The previous chapter describes the changes in the Swedish and international financial markets during the 1970s. As mentioned, the breakdown of the Bretton Woods system in the early 1970s was particularly important. It not only enabled new forms of cooperation in the

currency market but also facilitated a paradigm shift in economic policy and new regulatory measures, i.e., a change in the regulatory regime from what we have called the Statist Regime to the Market Regime.

The volatile economic development in the early 1970s, which was characterized by inflation, falling growth rates, and rising unemployment, led to changes in macroeconomic policy. Although different countries initially reacted unevenly, changes in the longer run were similar, at least across Western Europe, despite differences in ideological orientation among national governments. From the perspective of economic theory, these changes involved the gradual replacement of the Keynesian paradigm with a more market-friendly and monetarist approach. Since the mid-1970s, this shift can be seen in a strong disinflationary policy with high interest rates and the dismantling of administrative credit controls. In several countries, the German mark was used as the anchor for a stable currency.¹

With this new theoretical paradigm, regulation of the financial market was of the greatest importance. According to this theoretical approach, a well-functioning financial market could not be based on regulatory measures that impeded the functioning of a free market. Thus, measures to deregulate the financial market became an integral part of the new emerging regulatory regime. Changes in regulation of the British market spread to the European continent during the latter half of the 1970s and early 1980s. The abandonment of credit rationing systems in several European countries also became a vital component of disinflationary policy. In France and Spain, ceilings on new lending were viewed as a means to prevent inflation while maintaining a low interest rate. However, it was soon evident that these restrictions were not effective, because they could be circumvented by the market actors. This development was closely related to what occurred in Sweden, as discussed later.² The phenomenon of financial actors developing new financial products to circumvent regulations in a dialectic relationship to the regulations was discussed in Chaps. 1 and 2. It is also possible that the extent to which financial actors were able to circumvent regulations was exaggerated to support the argument for deregulation.

These new political priorities opened the door to changes in the activities of the national central banks. The most important task for central

banks was to keep inflation within specific parameters. Controlling lending through credit ceilings and implementing rules regarding interest rates were obsolete in the new regulatory regime. As a result, national banks were to a large degree released from political guidance.

As national restrictions on financial markets were abandoned, international financial transactions became easier to perform, especially with the growing use of computers. The international market was also stimulated by the increased flow of international capital. One effect of the oil crises in the 1970s was that capital from OPEC countries was transferred to Western European financial markets and made available to borrowers. International financial transactions increased in importance, and globalization of the financial market accelerated. The increased intensity of competition prompted structural changes in the international financial market and led to increased merger activity.³

Another important development in the international financial market that was directly connected to the increased importance of the financial market was the introduction of new financial instruments that revitalized the money market. Derivatives and other financial instruments were introduced, which created opportunities for new types of financing.

Thus, from the mid-1970s to the mid-1980s, the international financial market underwent sweeping changes. Increased competition and internationalization were built on less restrictive regulation relative to the previous financial regime. Regulatory changes were largely coherent for countries in Western Europe, although these changes were implemented at different times and at different speeds. Nevertheless, by the latter part of the 1980s, the new regulatory regime had been established in the international market despite differences in the details of macroeconomic policies between countries.

The Regime Transition in Sweden

As explained in the previous chapter, the Social Democrats suffered their first election defeat in 1976. A liberal/conservative government was installed, but, as noted above, this transition not lead to significant changes in terms of financial regulation. Except for the elimination of

Table 6.1 The deregulation of the Riksbank regulatory measures (1978–1990)

1978	Regulation of bank deposit interest rates eliminated
1980	Introduction of bank certificates
1982	Introduction of treasury bills
1983	Regulation of all bank interest rates eliminated
1983	Control of new bond issues eliminated
1983	Liquidity quotas eliminated
1985	Lending ceilings for banks eliminated
1986	Punitive rate on borrowing from the Riksbank eliminated
1986	Foreign banks allowed to establish subsidiaries
1986	Regulation of investment allocation for insurance companies eliminated
1989	Control of foreign currency transactions eliminated
1990	Foreign ownership in banks allowed

Sources Jonung, *Med backspegeln som kompass*; Berg and Grip, *Branschglidning mellan bank och försäkring*, 28–29

the regulation of bank deposit interest rates in 1978, no fundamental changes in the Riksbank regulation were implemented by the liberal/conservative government. Instead, during the years 1976–1982, the Riksbank regulation was used primarily to finance the increasing public debt,⁴ which can be linked to the choice facing Sweden and many other countries at this time, i.e., the choice between tightening regulations and eliminating them to resolve difficulties.

The sharp increase in the need for public capital in the 1970s and early 1980s could initially be handled with the Riksbank regulation, through liquidity quotas and regulations on investment allocation for insurance companies. In the early 1980s, however, this policy became increasingly problematic. Commercial bank assets were to a growing extent composed of bonds, which fueled money supply and inflation. In this situation, the government chose to allocate a larger part of the public debt among individual investors and companies through special savings bonds and other financial instruments. In July 1982, new treasury bills were introduced at a value of 1 million *kronor* or higher and with a term of not more than 2 years (Table 6.1). The interest rate on these short securities was not fixed but set by the market through bids. This new method for financing the public debt immediately became popular among buyers and soon the majority of the public debt was financed in this way.⁵

The success of these new savings bonds combined with a well-functioning secondary market made liquidity quotas less important for the financing of public debt, and in September 1983 they were eliminated. However, by 1980, the banks had already developed methods to circumvent liquidity quotas. By issuing so-called bank certificates, the banks could attract capital in addition to ordinary deposits, which could be used to purchase bonds without formally violating liquidity quotas.⁶

After the Social Democrats' return to power in 1982, the regulatory system changed rapidly. The shift toward belief in market efficiency had by now started to gain ground in the Social Democratic leadership. Minister of Finance Kjell-Olof Feldt had been trained in economics and had acted as the Swedish representative to international organizations such as the OECD, BIS, and the IMF, where he was likely exposed to the deregulatory discussions of the era. A similar trend within European Social Democracy to embrace market ideas was dubbed "the Third Way."⁷

The feeling among the staff at the Riksbank was that the regulations were undermined by the new money market. The new Riksbank Governor, Bengt Dennis—who had been appointed by the Social Democratic government after the election in September 1982—noted that the development of the money market made it possible for the banks to bypass virtually the entire Riksbank regulation. The methods to manipulate the system were fully developed, and the Riksbank could do nothing to prevent it.⁸ At the same time, the Riksbank had been staffed with an increasing number of people trained in formal economics that emphasized market efficiency and market equilibrium. Past regulations were thus increasingly interpreted as a textbook example of a price ceiling that led to a suboptimal outcome.⁹

In addition to liquidity quotas, the regulation of interest rates and new bond issues was eliminated in 1983. Lending ceilings were eliminated in 1985; the following year, the punitive rate on banks that borrowed from the Riksbank was eliminated. In the same year, foreign banks were allowed to establish subsidiaries in Sweden. Control over foreign currency transactions was officially eliminated in 1989 but had been unimportant for several years by then (Table 6.1).

The 1974 law that was the legal basis for the Riksbank regulation was not abolished but instead placed in mothballs in case it was needed in the future. There was thus some doubt that market orientation was a sustainable long-term solution for the financial system.

The dismantling of the Riksbank regulation was not the result of a political strategy but stemmed from several smaller decisions made during a short time. By contrast, thoughts of making changes to the regulatory system seem to have been circulating among market actors, the Riksbank, and politicians for some time. In 1980, the liberal/conservative government established a committee led by the chairman of *Handelsbanken*, Jan Wallander, for the purpose of analyzing the development of the credit policy. The findings of this committee were presented in autumn 1982, after the Social Democrats had assumed power. The committee supported deregulation of the financial market and argued that the Riksbank should guide credit through transactions in the open market. The committee's conclusion was that all liquidity quotas should be promptly eliminated but that certain regulations, such as the cash quotas, should be retained. The committee thus suggested a larger role for the free market but still within a framework of regulations.¹⁰

The elected Social Democratic government initially opposed to direct deregulation of the financial market and opted to maintain the policy of the liberal/conservative government. It began with a sharp devaluation of the Swedish currency to encourage exports. The liquidity quotas—which had not been used for some time—were reintroduced in early 1983 at a higher level than they had previously been. However, the increased public budget deficit had increased available liquidity on the market and thus the liquidity quotas were ineffective as a measure to control bank lending. The imbalance in the foreign accounts also contributed to volatile liquidity, especially among the larger banks, which created an uncertain situation for the financial market. The elimination of liquidity quotas was thus increasingly seen as necessary and was supported both by the Social Democratic government and the political opposition. Hence, they were removed in September 1983, as Sweden took another step toward deregulation.¹¹

Although the banks were given more freedom after the elimination of liquidity quotas, lending ceilings remained in place and were regarded as a more effective means of controlling bank lending. The lending ceiling limited lending growth to 4% in 1984. The regulation of insurance companies' investments was also retained, which meant that the financial market was still under extensive control by the Riksbank. In addition, insurance companies' lending was subject to interest rate control in 1984.

Insurance companies resented what they viewed as mistreatment compared to the banks and market development. The banks had greater freedom in both lending and setting their own interest rates. Another problem was that the Swedish National Debt Office (*Riksgälden*) had introduced a special so-called National Bond in the open market to help finance the budget deficit, and this bond had an interest rate 1.7% higher than the interest rate on ordinary government bonds, which the insurance companies were supposed to purchase. This resulted in strong protests not only from the insurance companies but also from BIS, for example.¹²

In the ensuing economic debate, the financing of the national debt through transactions on the open market was given increased attention. Additionally, public committees emphasized the importance of market transactions and supported the financing of the national debt through actors other than banks. Consequently, the interest rate of the so-called National Bonds became an important factor in the introduction of market-driven interest rates.

The Swedish discussion about deregulation of the financial market was closely related to international development. As Swedish membership in the European Communities (EC) became increasingly likely, there was a gradual adjustment to European standards. The Social Democratic government gradually implied that the Riksbank regulation was a restriction that could be used under extraordinary circumstances but that a market-oriented policy was preferable. When Financial Minister Kjell-Olof Feldt also came out in favor of the market solution, deregulation was not far off. Feldt noted in his memoir that Prime Minister Olof Palme, who was tired and distracted, finally accepted deregulation.¹³ The removal of lending ceilings in November 1985 was

dubbed the “November Revolution,” but as discussed earlier, this action was actually a step on an evolutionary path that spanned several years.

The dismantling of the Riksbank regulation increased the importance of ordinary banking legislation (presented in Chap. 2) for both commercial banks and savings banks. This resulted in a “double deregulation” for the savings banks because the full effect of the regulatory changes in the late 1960s (see Chap. 5) could not be realized until after the elimination of the Riksbank regulation.

An important regulatory shift also affected the Stockholm Stock Exchange, which as late as 1980 had been granted a monopoly on trading shares in Sweden. This was obviously a late example of the regulatory system that was developed after World War II, but this monopoly was very short-lived. Under the influence of the deregulation of the financial market in Sweden and abroad, Bengt Rydén, the CEO of the Stockholm Stock exchange since 1985, initiated a rapid development of the stock exchange. One important change was to reform the regulations and unbundle the stock market. An early step in this process was taken in 1987 when the government formed a committee to implement changes in the stock market. This led to an intense discussion about the future of the Stockholm Stock Exchange. With the support of specialists and politicians, the stock exchange was not only unbundled but also privatized in 1992.¹⁴

The Beginning of the Deregulated Financial Market

The new regulatory regime meant that the Riksbank was given a new role in the financial system. Through operations on the open market, the Riksbank remained a key actor in the market. The Riksbank was also active in the repurchase of different government securities and in the promotion of forward trade, which made it possible to relatively easily affect the liquidity of the financial market.¹⁵

As of the latter part of the 1980s, Riksbank policy was to allow the open market to develop as freely as possible. Expectations regarding

deregulation of the financial market were therefore very important. In the short run, household credit was expected to move from the so-called “gray” financial market of financial companies, where it had migrated to circumvent the regulations, back to the banks. There was no expectation that deregulation would result in uncontrolled credit expansion, and in the beginning, the banks’ total credit did not grow significantly. However, bank lending started to increase in 1987, which contributed to an overheated economy. The Riksbank noticed this trend and managed to persuade the banks to introduce amortizations with a final liquidation date on all new credit. However, the banks soon failed to conform to this policy. Indeed, this attempt to enforce new regulation was more in line with the previous regulatory regime. The situation had changed since then; liquidity was freely available and the banks were no longer dependent on the Riksbank to acquire it. Therefore, in 1988, the Riksbank abandoned its attempt to guide the credit market through direct means, allowing the banks to expand their lending freely.¹⁶

Between 1985 and the peak year of 1992, bank lending increased from 359 to 946 billion *kronor*—more than 160% (Fig. 6.1). The government did not tighten its fiscal policy, which might have been sufficient to cool off the economy. Increased lending was also fostered by a general increase of wages at the time, which made people willing to take on larger loans. Another factor was the banks’ prioritization of market growth: it was more important to be a dominant player in the market than to maintain the largest profit. The prioritization of size was deemed important to avoid hostile take-overs and to raise barriers to entry to prevent foreign banks from establishing themselves in Sweden. This was a common scenario, especially for the largest and mid-sized banks with growth ambitions. This environment created a “follow-the-leader effect,” which led to banks taking on large risks.

The largest part of the increase in bank lending in the late 1980s and early 1990s was in foreign currency. In 1985, foreign currency accounted for 26% of total lending. By 1989, it reached 38%, and in 1990 and 1991, it peaked at 44% of total bank lending. These were the years that immediately followed the elimination of Riksbank control over foreign currency transactions. Even before 1989, the Riksbank was fairly benevolent toward international transactions, but after Riksbank

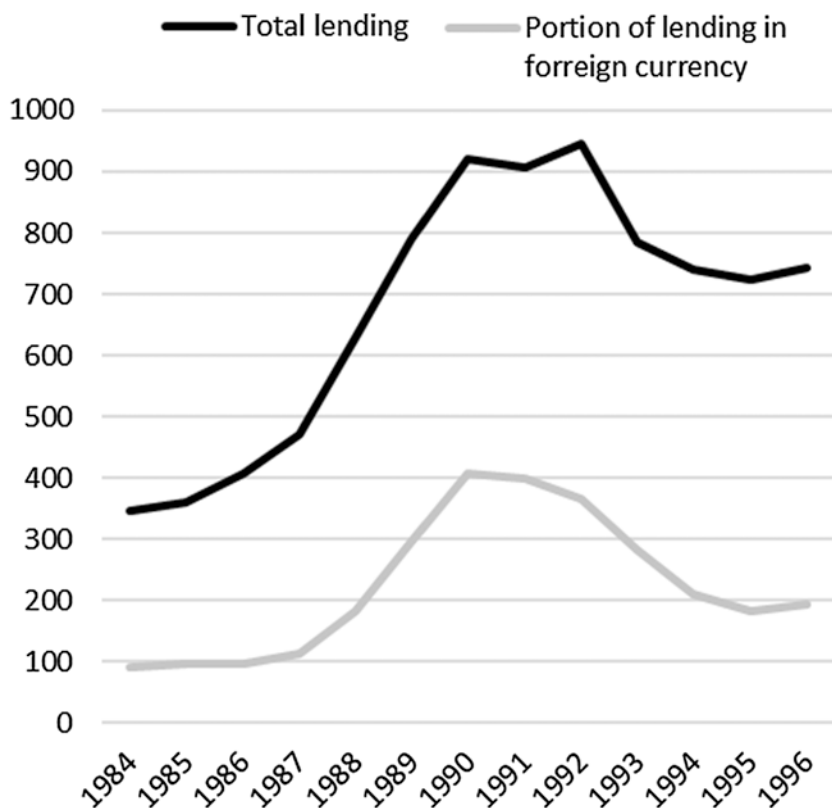


Fig. 6.1 Total bank lending during 1981–1996 in billion kronor. Source Riksbank annual reports

control was eliminated, it became much easier from a bureaucratic perspective to borrow money from abroad at a low interest rate and lend it on the Swedish market at a considerably higher rate. After the devaluation of the Swedish Krona in 1981 and 1982, it was widely expected that the value of the Swedish currency would remain unchanged. This expectation was strengthened in 1991 when the exchange rate for Swedish Krona was pegged to the ECU. Thus, the risk associated with loans in foreign currencies did not seem to be higher than that for loans in Swedish *kronor*.

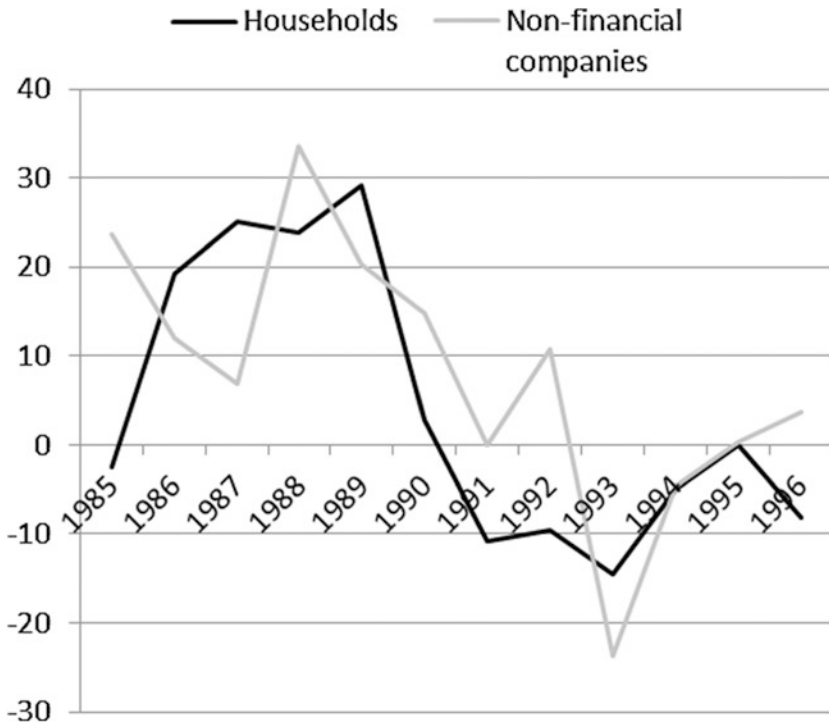


Fig. 6.2 Annual change in bank lending to households and non-financial companies during 1985–1996 in percent. *Source* Riksbank annual reports

Households reacted swiftly to deregulation of the financial market. In 1986, lending to households increased by 20%; during the following years (1987–1989), annual growth fluctuated between 20 and 30% per year. Credit to non-financial companies also increased considerably, especially in 1988, when the growth rate exceeded 30%. During the early 1990s, the growth of loans to non-financial companies was considerably higher than that for households (Fig. 6.2).¹⁷

Considering interest rate trends, this expansion was remarkable. During the latter half of the 1980s, interest rates for deposits varied between 8 and 10% while the lending rates fluctuated between 12 and 14%. Thus, the difference between deposit and lending interest rates

was approximately 3% during the late 1980s. This difference gradually increased, reaching 7% in the early 1990s.¹⁸ This discrepancy allowed the banks to finance loans in the Swedish market with capital borrowed from the international market and earn more than if lending were financed with deposits. Clearly, high lending rates combined with increased foreign capital credit created higher risks for borrowers and, as we discuss below, for the banks.

At the same time, lending was growing, and there was some relatively minor relocation of lending among different groups. The role of households was more or less stable, but the share of loans to public authorities decreased due to budget restrictions while credit extended to industry and commerce increased in relative importance. The most expansive industry by far was the building and real estate sector. Expectations of a boom in the real estate market attracted both entrepreneurs and capital. New companies were established, and houses and apartments—particularly those centrally located in larger cities—were sold at an increasing rate at escalating prices. These customers were originally clients of commercial banks, but the new market environment allowed both savings banks and the former cooperative agriculture banks to compete for these customers. Savings banks were particularly active in financing the expanding real estate market in larger urban areas.¹⁹

Speculators in the expanding real estate market often took advantage of the laxity that developed regarding the need for collateral. Credit without collateral was very unusual in the 1970s—before 1979, only a very small percentage of total deposits was allowed to be loaned without collateral. In 1979, this limit increased to 10%, and in 1987, this restriction was abolished and replaced by an open regulation that allowed the banks to decide whether and what kind of collateral would be required for loans. In 1989, 25% of all credit was granted without collateral, whereas mortgage loans and claims on financial institutes—both of which offered strong collateral—collectively accounted for only 33% (Table 6.2).²⁰

The extension of credit without security was seldom used for ordinary household loans. Instead, unsecured credit was frequently extended for building activities, real estate, hotels, and restaurants. In these industries, approximately 60% of all credit was granted without collateral; in

Table 6.2 Collateral as a percent of total commercial bank credit 1989

Mortgage loans	15
Shares as collateral	8
Name collateral	8
Claims on other financial institutes	18
Other collateral	26
No collateral	25

Source SOS, *Uppgifterna om bankerna 1989*

other industries, unsecured credit accounted for between 10 and 20%.²¹ This practice is a good example of the increased risk that developed in the financial system as the use of collateral was undermined. Note also that the large segment of “other collateral” included assets of doubtful value, such as shares of non-public companies or claims against invoices or credit cards.

The Financial Crisis of the 1990s

As we have discussed, the risks associated with banking increased during the 1980s, in part as a result of changes in public policy and regulations. Although these problems are obvious in hindsight, they were quite difficult to perceive as the economy boomed, unemployment was low, and profits were high. There were only a few warnings that lending was growing too fast, including the warning expressed by Financial Minister Kjell-Olof Feldt.²² It is not surprising that the banks defended the new financial regime because criticism of the deregulated market might have been interpreted as the banks’ recognition that new regulations were needed. Moreover, neither the Riksbank nor the Bank Inspection Board (as of 1991, the Financial Supervisory Agency) was especially eager to counteract the rapid development of the financial sector and the risk of an overheated credit market.

A common view is that the Swedish financial crisis started with the cancellation of payments by the finance company *Nyckeln* (“The Key”) in September 1990. It is true that this action was of symbolic importance. In late summer of the same year, industrial production had

peaked, as had real estate prices. Economic stagnation was approaching, and the cancellation of all payments by one of the Sweden's largest financial companies was therefore a very important incident. This cancellation was followed by the liquidation of several other financial companies, most of which were non-bank controlled. Increasing interest rates during autumn 1990 made the situation even worse, and this trend continued in 1991. During these 2 years, financial companies experienced losses corresponding to nearly 20% of their lending, which was closely related to falling demand for credit and reduced prices on real estate that had been financed by the financial companies. This situation can be compared to the developments in Norway a couple of years earlier, when financial companies played an important role in the commencement of Norway's financial crisis, which soon spread to the banks. As in Sweden, financial companies in Norway had a more aggressive sales culture and took greater risks compared with traditional banks.²³

In Sweden, the crisis among financial companies was closely linked to the real estate industry. As prices on real estate stagnated, financial companies had to take control of real estate collateral and sell it on the market at falling prices, which in turn triggered a downward spiral of prices that impacted other financial companies. Several financial companies were owned or financed by banks, and banks had also directly financed building activities and real estate investments. As early as 1988, there were signals that prices on some real estate—for example, business properties in urban areas—had increased too rapidly relative to the rental income earned from the investment. The high Swedish interest rate also clearly motivated lower prices on real estate. Therefore, to maintain a stable income, the financial companies and real estate managers needed to sell at prices higher than the purchase prices. In some corporate groups, this was achieved by selling houses at continuously rising prices to companies within the same business group. This practice drove prices even higher and stimulated the overvaluation of real estate.²⁴

The first bank to be seriously hit by the crisis was the partially state-owned *Nordbanken*, which had close ties to one of the largest financial companies, *Gamlestaden*. When *Gamlestaden* encountered financial

Table 6.3 Commercial bank credit losses as a percent of total lending

Year	Credit losses
1989	0.4
1990	1.1
1991	4.0
1992	6.4
1993	6.2
1994	2.1
1995	1.3

Note Credit losses for 1992–1995 include losses by savings banks and cooperative banks (*Föreningsbanker*).

Sources SOS, *Uppgifter om bankerna 1989–1994*, SOS, *Finansiella företag 1995*

problems, *Nordbanken* and other financiers provided support through the extension of new credit. In 1991, falling real estate prices made the situation intolerable and *Gamlestaden* canceled its payments. This resulted in large losses for *Nordbanken*, among others. During the following years, all large banks experienced credit losses. At first, these losses originated from the real estate sector, but they gradually spread to other industries as the economic downturn worsened and companies and individuals started having difficulty servicing their debts, which in turn led to credit losses for the banks.

The first year characterized by large credit losses for the banks was 1991, when 4% of total lending was lost. The losses increased during the next 2 years but fell sharply in 1994 (Table 6.3). Commercial banks were not the only banks hit hard by credit losses; savings and cooperative banks also encountered losses, some of which were even larger than those suffered by the commercial banks. Small banks that operated in local environments where they knew many of their customers and that had not been active in urban markets were significantly better off.

Among the largest commercial banks, two stand out as the hardest hit: *Nordbanken* and *Gota Bank*. Both banks had actively sought new customers after deregulation and had taken greater risks than *Handelsbanken* and the Wallenberg-owned *SEB*, which had a long tradition as financiers of Swedish industry and thus could rely on their traditional contacts instead of taking higher risks to attract new loan customers.

What Caused the Crisis?

Deregulation of the financial market was an important factor behind the banking crisis, but public policy exacerbated the situation. For several decades, borrowers' interest rate payments had been tax deductible, which encouraged borrowers to increase their loans, especially if they had large taxable incomes and paid high marginal taxes. In fact, high inflation made it possible to earn a profit merely by borrowing more money. With an interest rate of 14% and a marginal tax rate of 50% (the highest marginal tax rate was 80%), the actual interest rate would be 7%. With inflation of, for instance, 10%, the real interest rate would be minus 3%, which means that Swedish borrowers were actually paid by the state to borrow money from the banks.²⁵ Nonetheless, this paradoxical situation had not been a problem when the Riksbank regulation restricted the extension of credit.

In the mid-1980s, political discussions started to address a reduction of the marginal tax and a simultaneous halving of the allowable deduction. However, it was not until 1990–1991 that these changes were implemented as a result of a political compromise. Because the financial crisis was then already in its early stages, the timing of the changes was not at ideal. If these changes had been implemented before the deregulation of the financial market or the lending market, it is possible that the lending boom and the financial crisis could have been mitigated.

As was the case in previous decades, the international situation was also important. The decision to maintain a stable exchange rate against the ECU had been made in May 1991 for the purpose of stabilizing the economy. The unification of Germany was followed by massive German government expenditures to stimulate development in Eastern Germany. To counteract inflationary pressure, the central bank implemented a contractionary monetary policy, which drove up interest rates. Higher interest rates caused capital to flow out of Sweden in search of more profitable investments, which placed pressure on the value of the Swedish currency. International speculators, with George Soros at the forefront, started to speculate against the Swedish currency. The Riksbank was forced to purchase the national currency in order to

protect the stable exchange rate. It gradually increased the key interest rate, and for a short period (September 16–21, 1992), it reached 500%. This increase had immediate effects. Specifically, interest rates in the private lending market reached 25–30%, but speculation against the Swedish currency was only temporarily slowed. When the speculation resumed in November of the same year, it was impossible to defend the Swedish currency any longer. It was clear that this policy could not continue, and when the currency was allowed to flow freely, devaluation was a direct consequence.²⁶ The decrease in value of the Swedish currency stimulated exports and likely helped the Swedish economy to recover from the financial crisis.

The more direct reason that the crisis was stopped was that the government stepped into support the system. The use of this approach to handle the crisis followed the same pattern as that used during the interwar crises. In late summer 1991, the state acted as owner and guaranteed the issuance of new shares in *Nordbanken*. This action can be viewed as an act of ownership, but the state also acted as a lender of last resort during autumn 1991. One of the largest savings banks in Sweden incurred extensive losses on their lending to building and real estate interests. Assistance from other savings banks and the state's willingness to act as a guarantor made it possible to save this bank.

In 1992, the state had to take action again to save the Swedish financial system. In January and April of that year, the state had to support *Nordbanken* by purchasing newly issued shares. These purchases made the state the sole owner of *Nordbanken*; a year earlier, it had owned 70%. A large part of this newly infused capital was used to transfer “bad credit” from the bank to a specially established “bad bank” called *Securum*, which had the mandate to sell the collateral connected to the loans in default.²⁷

Nordbanken was by far the bank hit hardest by the 1990s crisis in terms of capital losses. Nevertheless, the bank managed to survive, and after the transfer of bad credit, it was able to expand its operations. It expanded primarily through mergers, mainly with banks outside Sweden. The situation was worse for another bank that rapidly expanded in the 1980s: the *Gota Bank*. It was purchased by the insurance company *Trygg-Hansa/SPP*, just before the banking crisis. The

new owners initially tried to support the bank with additional capital, but when credit losses increased heavily during the summer of 1992, the state had to takeover the bank. As in the *Nordbanken* case, a special “bad bank” was established for the loans in default. The healthier part of the *Gota Bank* business was taken over by *Nordbanken*.²⁸

These events occurred at approximately the same time that speculations against the Swedish currency started. The growing instability of the Swedish financial market and Swedish currency made international financiers more reluctant to invest in Sweden. To stabilize this situation and establish more solid routines for handling distressed financial companies, a special state authority was created: *Bankstödsnämnden* (The Bank Support Commission). The Commission began its activities in early 1993, and both banks and mortgage institutes could apply for support. However, the need for public support quickly diminished after the floating exchange rate was introduced in November 1992. Nonetheless, the Commission was still responsible for handling previously accepted state support and was the controlling owner of *Nordbanken*. The financial crisis resulted in state capital support that fell just short of 65 billion *kronor*, 95% of which was related to the support of *Nordbanken*.

In the aftermath of the crisis, the Bank Inspections Board was subject to heavy criticism for failing to warn against increased lending and insufficient collateral. However, the Bank Inspections Board was not accustomed to dealing directly with the banks. The Riksbank regulation was enforced by the Riksbank, not the Bank Inspections Board, which mainly collected monthly information and focused on the banks' accounting. When the financial market was deregulated in the 1980s, the Bank Inspections Board reduced its activities. The Board was not supposed to intervene in bank business; rather, the market was supposed to guide the actors' behavior. Therefore, the ethics notifications previously issued by the Bank Inspections Board were discontinued, and its visits to banks became increasingly infrequent. Its tight budget and regulations that restricted the introduction of new standards (not laws) also hampered the Board's ability to develop control measures. Thus, a large part of the Board's failure to exercise effective control over the bank sector can be explained by policies enacted by the Swedish

government.²⁹ In 1991, the Bank Inspections Board was merged with insurance inspections to form the Swedish Financial Supervisory Authority (FSA), whose budget and power increased as a result of adjustments to membership in the EU.

Long- and Short-Term Consequences of the Crisis

During 1993, the Swedish financial market was stabilized, primarily owing to the floating exchange rate but also as a consequence of state support. The financial market system gradually adjusted to international standards and to a banking environment that was not characterized by overheating and a lending boom. This process can be illustrated with the ratio between lending and deposits. Before the sharp increase in lending in 1987, bank deposits financed approximately 90% of banks' total lending. As the role of foreign capital in the banks' balance sheets grew, lending was financed to a lesser extent by deposits. In 1989–1990, banks' total lending amounted to 140% of deposits but then fell gradually to the pre-crisis level by 1994 (Fig. 6.3).

Conclusion

Usually, financial crises lead to regulatory changes. When the roots of the financial problems have been identified, new regulations are often introduced to counteract similar developments in the future. An example of this can be found in Sweden in the 1920s, when banks' right to own and trade shares was identified as the main problem in the banking system and therefore gradually abolished. By contrast, after the crisis in the 1990s, no major changes in the banking legislation were introduced. Instead, the adjustment to EU regulations continued (Sweden became a member in 1995). In fact, the only modification of significance was that commercial banks were once more given the right to own and trade shares, which had been abolished after the Kreuger crash in 1932.³⁰

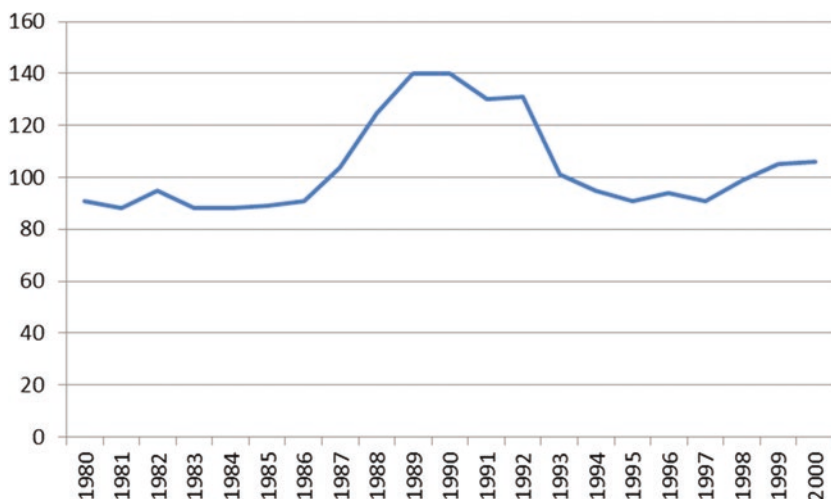


Fig. 6.3 Banks' lending/deposit ratio during 1980–2000 in percent. *Sources* Sveriges Riksbank, annual reports

A tendency toward concentration in the financial market began during the 1980s. As a consequence of the regulatory changes in 1987, it became possible to integrate banking and insurance in the same business group. This situation encouraged mergers across business borders, and during the following years, there were several examples of integration among banks, insurance companies, and mortgage institutes. This policy continued after the financial crisis both as a consequence of the internationalization of the financial market and as a means to avoid the liquidation of weak companies by merging them into their stronger competitors. This trend opened the door to the creation of large financial “department stores” at which virtually all financial transactions could be conducted. As competition from foreign actors increased in the Swedish financial market, this strategy became a means to strengthen market actors, especially the larger banks.

Deregulation of the financial market in the 1980s constituted a transition period between two regulatory regimes: the regulatory postwar regime and the market-oriented regime. Although the transition period

between these two regimes was comparatively short, the regulatory foundations changed considerably—especially through the elimination of the Riksbank regulation—and the market opened up to competition from both national actors and international competitors. It is difficult to overstate the importance of the European Union in this process. Even before Sweden applied for membership in the EU in 1990, regulations were altered to correspond to European standards. Based on the experiences of the financial crisis in the 1990s, it is likely that these adjustments could have been implemented more smoothly and at a lower cost to both the state and the banks.

Notes

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12. Svensson, *Novemberrevolutionen*, 49–50.
13. Svensson, *Novemberrevolutionen*, 52–55, Feldt, *Alla dessa dagar*, 254–255.
14. Larsson, *Stockholmsbörsen på en förändrad finansmarknad*, 32, 56–58.
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28. Petersson, *Ägarstyrning under institutionell och organisatorisk förändring*; Lönnborg et al., “One Hundred and Fifty Years of Financial Crises in Sweden”.
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7

Banking Development, the Global Financial Crisis and the Basel Regulations: 1995–2015

Abstract This chapter describes the development after the crisis in the 1990s and up till 2015. The Swedish banking sector expanded considerably, especially in its cross-border activities. The global financial crisis in 2008 put stress on the sector, particularly because of its engagement in the Baltic States, and a series of precautionary steps were taken by the Swedish government and the Riksbank. A global re-regulatory agenda started after the crisis which has had large importance for the Swedish financial system.

Keywords Basel III · Global financial crisis · Riksbank · Sweden

This chapter provides a brief history of the development of the Swedish financial sector from the end of the financial crisis of the 1990s to the present. In Sweden, the crisis tended to reinforce the principles of the Market regime. Even the Social Democrats had by 1990 conceded that keeping inflation in check was the most important macroeconomic goal.¹ During the crisis, a government commission led by leading economist Assar Lindbeck identified reforms that would be necessary

to ensure a more market-oriented Sweden.² The proposed steps were aimed at dismantling the remnants of the Social Democratic postwar program described in Chap. 2. The commission also concluded that the Riksbank should be given formal independence to prevent politicians from using monetary policy to achieve political ends.

In the EU, preparations for the launch of the euro took place. Similar ideas regarding the need to maintain an independent central bank and to target inflation were prevalent in that realm as well. Consequently, Swedish membership in the EU entailed a commitment to central bank independence. In the aftermath of the financial crisis, the Riksbank had already started to target inflation at 2%,³ and it was given formal independence through legislation in 1999. This was more or less the codification of the dominant economic theories of the time, which emphasized the need to ensure low and stable inflation by decoupling monetary policy from politics and by maintaining stable inflation expectations.⁴ This school of thought implicitly assumes that if inflation is kept under control, financial stability will ensue because actors know what to expect. This combination of ideas was later summarized as the “Jackson Hole Consensus”: monetary policy is the best means of economic stabilization; central bankers should be insulated from politics; low inflation is critical; markets are efficient; and financial crises are a thing of the past.⁵

Banking Expansion and Internationalization

The Swedish banking sector expanded considerably in the years after the crisis. A tendency toward concentration in the financial market had started during the 1980s and accelerated during the crisis in the 1990s, not least due to mergers stemming from the government’s crisis management. By 2015, the four major Swedish banks—*Handelsbanken*, *Nordea*, *SEB*, and *Swedbank*—accounted for 70% of all lending in Sweden and nearly as much of the deposits.⁶

The Swedish banking sector also grew rapidly. After the crisis in the 1990s, the assets of the Swedish banks amounted to approximately 120% of GDP. By 2008, the value of these assets had reached approximately 370% of GDP.⁷ Growth also took place outside Sweden,

especially in other Nordic countries but also in the Baltics, Germany, Poland, and the UK.⁸ As a result of this considerable expansion, the Swedish banking sector is now one of the largest in Europe relative to GDP.⁹

Another crucial development was the banks' increasing focus on housing loans.¹⁰ During the real estate boom of the 1980s and 1990s, the banks made large loans to both residential and commercial real estate. Although the crisis originated in commercial real estate, it also caused the prices of residential housing to fall and resulted in a decline in bank lending. Lending for residential housing started to increase again in the second half of the 1990s and expanded rapidly in the early 2000s. As competition between the banks intensified, the banks relaxed their loan demands, in many cases by eliminating the amortization requirement and reducing the amount of the required down payment. Furthermore, interest rates were low both internationally and in Sweden, which meant that it was generally inexpensive for households to service their debts. Relatively strong economic performance and rising wages further boosted confidence that credit expansion was not a problem.

The relationship between banks and real estate grew stronger. Previously, Swedish banks typically owned mortgage banks but were formally separated from them. This arrangement meant that lending for residential purposes was kept separate from banks' other activities, which was motivated by the perceived risk of financing long-term housing loans with short-term bank funding. Through the introduction of so-called covered bonds—bonds issued against the collateral of existing house loans—Swedish banks were able to cheaply finance rapid expansion with bonds considered to have low risk. Market lending therefore became a more important form of funding than more traditional deposits. An increasing portion of this market funding comprised short-term and non-Swedish currencies. Hence, the internationalization of the Swedish banking sector traveled in two directions: one outward, as Swedish banks expanded across the border, and one inward, as Swedish banks increasingly financed themselves with international money.

The Global Financial Crisis and its Effects on Sweden

The global financial crisis that originated in the subprime mortgage sector in the USA in 2007–2008 has been analyzed in countless papers and books.¹¹ Swedish banks had very little exposure to the American financial market at the time of the crisis. However, European banks owned securities based on American subprime loans. Bad assets were thus circulating, but it was difficult to know which banks owned them and in what amounts. The crisis in the USA thus triggered widespread suspicions among banks in Europe that they could not safely lend money to one another.¹² This reluctance to make loans to other banks threatened short-term finance, which is the lifeblood of banks. The liquidity problem was worsened by the fact that European banks—including Swedish ones—needed American dollars to settle their daily activities. This need for American dollars created a challenge for central banks that stemmed from the increasing internationalization of banking—specifically, the banks needed American dollars, but the central banks of their respective countries could not create dollars; only the American Federal Reserve had the power to do this.

Both the government and the Riksbank made clear commitments to ensure that the Swedish financial sector was not dragged into the financial crisis. On October 29, 2008, Parliament approved the so-called Stability Plan presented by the government, and a voluntary state guarantee program was launched. This program allowed banks, mortgage banks, and other financial institutes to obtain state guarantees in exchange for a fee and restrictions on salaries and bonuses. The purpose of the program was to reduce the cost of funding the institutes by reducing the associated risk. Of the four major Swedish banks, only *Swedbank* chose to participate. Parliament also legislated that state support to a credit institute was permissible to maintain financial stability. Finally, a decision was made to create a stability fund, starting with 15 billion *kronor* of government money, to finance government actions to ensure financial stability. Money paid by institutes as part of the above-mentioned guarantee program was channeled into this fund.¹³

The Riksbank stepped up as the lender of last resort by standing ready to lend liquidity to banks that were solvent but experiencing temporary liquidity problems. There were three channels of liquidity support: general liquidity support, special liquidity support to specific institutes, and liquidity support to neighboring countries in connection with the Baltic crisis.¹⁴ Mistrust in the market manifested as difficulties experienced by banks in obtaining loans with longer maturities. The Riksbank therefore started to issue loans with 12-month maturities to banks. Since there was a need for American dollars, the Riksbank entered into swap agreements with the Federal Reserve and was thereby able to fortify its currency reserves with additional dollars. Dollar loans were in high demand, and the Riksbank loaned the equivalent of 200 billion *kronor* in dollars.¹⁵ In addition, emergency liquidity loans were extended to the ailing Kaupthing Bank Sverige and Carnegie Investment Bank. Both were minor institutions, but given the severity of the situation, the Riksbank decided that the risk of a loss of confidence in the market if these institutions went bankrupt was too large and thus opted to issue emergency loans. Both institutions were later dissolved.

The considerable expansion of Swedish banks into the Baltic States became particularly problematic. These nations experienced bubble-like economic growth in the 2000s, and the financial crisis had a severe impact on their economies. In 2009, their collective GDP contracted by 20%.¹⁶ Swedish banks, especially *SEB* and *Swedbank*, had loaned approximately 400 billion *kronor* in these countries. Together, the subsidiaries and branches of these banks accounted for 80% of the Estonian market, 55% of the Lithuanian market, and 60% of the Latvian market.¹⁷ The sharp economic contraction therefore threatened Swedish banks with huge losses, much of which was in non-Swedish currencies. Half of the losses sustained by Swedish banks was attributable to the Baltic countries. There was a risk that the Baltic situation would spill over into the Nordic countries, including Sweden. The situation in Latvia was particularly bad. In late 2008, Latvia signed an agreement with the IMF and EU for access to euros. In addition, the Riksbank and the Danish central bank jointly entered into a swap

agreement with the Latvian central bank to provide further assistance. Later, a similar agreement was made with the Estonian central bank.

It is impossible to know how close Sweden came to a financial meltdown. The stress tests performed at the time by the FSA suggest that the banking sector was well equipped to withstand the losses on Baltic assets.¹⁸ Another view was offered by the Swedish Finance Minister at the time, Anders Borg. Borg said that if the IMF and the EU had not stepped into lend money to Latvia, two major Swedish banks would have collapsed. He did not name these banks specifically, but it is generally assumed that he was referring to *Swedbank* and *SEB*.¹⁹ Since the Swedish financial system was by now very concentrated and highly interconnected, it is likely that if one of these banks had collapsed, a systemic crisis would have ensued.

Regulatory Responses to the Global Financial Crisis

In a 2009 speech held at the Swedish Banking Association, Riksbank Governor Stefan Ingves used the metaphor of a swinging pendulum to explain regulatory shifts: “For those of us who have been around for a while, it is a movement, a pendulum that swings to and fro between many and few regulations, and at present the pendulum is swinging towards more regulations.”²⁰

The swing toward increased regulations was an international phenomenon. Paradoxically, the momentum had been building during the deregulation of international financial markets. In response to the financial turmoil of the early 1970s, particularly the failure of the German bank Bankhaus Herrstadt, the G10 countries, including Sweden, agreed to establish an international organization for bank supervision in 1974. This organization became the Basel Committee for Bank Supervision (BCBS) and was headquartered at BIS in Basel.²¹ Its original aim was to facilitate cooperation among national authorities to make it more difficult for banks to circumvent regulations and to harmonize regulations between member nations.

A crisis that occurred at the beginning of the 1980s, the so-called Latin American debt crisis, prompted the BCBS to develop its agenda further. In 1988, the Basel Capital Accord (now usually referred to as Basel I) was unveiled. This accord was based on the need to strengthen the robustness of international banks by increasing their capital levels, i.e., the part of their financing that is not debt. During the 1990s, this framework was criticized for lacking risk sensitivity and failing to incorporate new methods of risk assessment. Work therefore began to produce a new accord, and the result was Basel II in 2004. However, Basel II was short-lived because the global financial crisis in 2008 showed that the scope of the problem was greater than previously assumed. Basel III was therefore developed through a lengthy process and was subsequently supplemented and expanded. The sheer number of regulations included in Basel III has been criticized as making it too complex.²² Several of the most important areas of regulation should be highlighted: higher capital levels to ensure robustness to losses, liquidity regulations to ensure that banks have more access to liquidity, and more stringent demands on large institutions deemed to be of systemic importance. These standards are not binding on member countries and allow some national flexibility. Most members have chosen to implement them, albeit with differences in the details across countries. Sweden's membership in the EU means that many Basel III regulations have been incorporated into Swedish laws as part of the country's continual adherence to EU legislation. The banking sector has been critical of many of these regulations, warning that they reduce the efficiency of the financial sector, which will have consequences for economic growth. In Sweden, the Swedish Bankers' Association has been a particularly vocal critic.

Increased awareness of financial instability also led to the creation of new bodies for international cooperation. In 2009, the G20 countries agreed to create the Financial Stability Board (FSB), which replaced a previous organization, and gave it the mandate to promote international financial regulation. One of its key concerns is the problem of "too big to fail." Arguably, a financial institution must be able to fail without endangering the stability of the financial system or placing taxpayer money at risk. International and national regulators have attempted to build a regulatory framework around this notion, and the

resulting so-called resolution framework contains a number of tools. For instance, it will be possible for nationally assigned resolution authorities (in Sweden, the National Debt Office) to intervene if a bank is near bankruptcy and to demand emergency action on behalf of the bank. Another highly publicized tool in the resolution framework is the so-called bail-in, which will make it possible to transform an institution's debt into capital, effectively turning its creditors into shareholders. In the EU and Sweden, the details of the resolution framework remain under construction.

The financial crisis not only resulted in new regulations but also led to a more active role for the Swedish Financial Supervisory Authority (FSA). In 2009, the FSA was required to increase its control over bank activities connected to money laundering and financing of terrorism; in 2013, it was given broader powers to counteract financial instability related to increased lending to households, among other activities. These laws were closely connected to EU regulations and required the FSA to increase its control over individual banks and to follow banks' activities more closely. In addition, the FSA was directed to report banks' activities and to disclose its own findings to the government.²³ Compared to the 1980s and early 1990s, the FSA had a significantly more active role in the banking sector and the potential for self-regulation among banks was reduced. This development affected not only the banks but also other parts of the financial sector, including the insurance industry and the stock market.²⁴

Notes

1. Lindvall, "Politics of Purpose", 265.
2. SOU 1993: 16. For more on the Commission, see Lindbeck, *Ekonomi är att välja*, and Offer and Söderberg, *Nobel Factor*.
3. Jonung, *Med backspegeln som kompass*, 217.
4. SOU 1993: 20; Jonung, *Med backspegeln som kompass*, 220.
5. Irwin, *Alchemists*, 97–98.
6. Riksbanken, *Financial Stability Report 2016: 2*, 14.
7. Ingves, "Finansiell stabilitet", 1.
8. Riksbanken, *Structural Changes in the Swedish Financial System*, 34.
9. Riksbanken, *Financial Stability Report 2016: 2*, 14.

10. The following section is based largely on Riksbanken, *Från ax till limpa*.
11. Reinhart and Rogoff, *This Time is Different* and Stiglitz, *Free Fall* to name just a few.
12. Irwin, *Alchemists*; Molin, “Hur har Riksbanken hanterat den finansiella krisen?”.
13. Bergström, “Finanskrisen och den svenska krishanteringen”16.
14. The following section is based on Molin “Hur har Riksbanken hanterat den finansiella krisen?”.
15. Ingves, “Tid för omprövning”, 14.
16. Staehr, “Austerity in the Baltic States”.
17. Ingves, “Krisen in Baltikum”, 1.
18. Finansinspektionen, “Finansinspektionens stresstester av storbankerna”.
19. “Borg: Swedbank hade kraschat”. 2011. Realtid. <http://www.realtid.se/borg-swedbank-hade-kraschat>. Accessed on February 14 2017.
20. Ingves, “Finansiell stabilitet”, 1.
21. This section builds primarily on “History of the Basel Committee”. 2016. Bank of International Settlements. <http://www.bis.org/bcbs/history.htm>. Accessed on April 23, 2017. See also Goodhart, *Basel Committee of Banking Supervision* and Haldane, “Dog and the Frisbee”.
22. Haldane, “Dog and the Frisbee”.
23. SFS 2009:93; SFS 2013:111.
24. Larsson, *Stockholmsbörsen på en förändrad finansmarknad*.

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Finance and the Welfare State: What Have We Learned?

Abstract This chapter concludes the book on financial evolution and regulatory regimes in Sweden. It summarizes the lessons learned from the Swedish experiences from banking development and banking regulations, and ends with discussing the question whether a new macroeconomic regime is being initiated.

Keywords Financial crises · Macroeconomic regimes · Regulations
Basel regulations · Social democracy

This book provides an overview of the Swedish experience of financial regulation and development from around 1900 to 2015. It places special emphasis on the interaction between national and international phenomena and on how financial regulations are usually connected to larger shifts in general macroeconomic policy. This chapter distills a number of key points from the Swedish experience.

Regulations Are Likely a Necessary Part of a Functioning Financial Market

After the deregulation of the Swedish financial market in the 1980s, bank lending accelerated quickly, increasing by more than three times between the middle of the 1980s and the early 1990s. A large part of this credit expansion was connected to private borrowing and to loans to real estate and building interests. There are many factors that might explain this trend, ranging from the inexperience of the banking sector and low real interest rates to tax reform and the unification of Germany. Likewise, the global financial crisis of 2007–2008 could be explained by low interest rates or the specific details of American bankruptcy laws or housing policy. All individual financial crises could likely be explained away in this manner, i.e., as the result of a particularly unfortunate set of factors. The specific factors may change, but the fact remains that the financial sector appears to be inherently unstable and if not sufficiently regulated, it will end up in crisis.

Large Regime Shifts Are International but Domestic Politics Matter

Shifts in broad views of how financial markets should be regulated generally occur in tandem with shifts in views of how macroeconomic policy should be conducted. Thus, both domestic economic policy and international exchange rate regimes seem to be connected to financial regulation. We have used the term “macroeconomic regime” to describe these complex policies based on overarching principles. Sweden was typically late to adopt these regimes, probably owing to the close interaction between the international and national levels. In particular, a small country cannot change its macroeconomic and regulatory principles by its own without severe consequences. If we look at the Swedish situation, there was only a limited increase of the role of the state in the 1930s, whereas several other countries implemented a larger degree of state control. By contrast, when the Swedish financial regulatory regime

was altered in the 1950s, the changes were considerable and the financial system came under rigorous state control. Sweden was also late in adopting a disinflationary and more market-oriented policy. Although several countries adopted this type of policy in the 1970s, it was not until the mid-1980s that this became the main policy in Sweden, through rapid and somewhat uncontrolled deregulation. The Nordic financial crisis in the early 1990s did not reverse this course. Instead, it was only after the global financial crisis of 2007–2008 and the subsequent international regulatory agenda that Sweden once again started to tighten financial regulations.

The importance of international factors does not mean that domestic policy orientation is not important. What is striking about the Swedish example in comparison with several other Western European countries is the level of detail in the regulations introduced by the Swedish Riksbank in the 1950s. Several other countries—for example, Norway and Spain—introduced similar regulations but never went into the same level of detail that Sweden did. It is not far-fetched to regard this level of detail as a consequence of the establishment of the Swedish model and the welfare state. Strict control of the financial market was intended not only to stabilize the Swedish currency but also to guarantee that capital would be available for investment in infrastructure and to finance large government expenditures. One can see these goals as part of the ambitious social program launched by the Social Democratic Party toward the end of World War II and the construction of the so-called Swedish model. The end of the Riksbank regulatory system in the 1980s also coincided with increasing doubts about key aspects of the Swedish model, even among Social Democrats.

The Role of Individuals in Key Positions Is Important

Both the introduction and elimination of the Riksbank regulation were closely related to individuals who acted as catalysts for these events. The introduction of the Riksbank regulation was due in large part to Mats

Lemne's preparatory work at the Ministry of Finance. When Lemne was made Governor of the Riksbank, he had unique opportunities to influence the use of the regulation and to shape the new regulatory regime. Lemne's successor, Per Åsbrink, also came from the Social Democratic Party and played a large role in the continued application of the regulation. However, as discussed above, he also drove the increased internationalization of the Riksbank and orchestrated the end of the low interest rate policy.

The Bankers' Association played a major role in representing the interests of the banks. In particular, its chairman had the opportunity to influence the interpretation of the Riksbank regulation, especially during its establishment. Ernfrid Browaldh from *Handelsbanken* played an important role in the introduction of the Riksbank regulation for insurance companies by developing the compromise that both insurance companies and the Riksbank could accept. During the deregulation process, individuals such as Bengt Dennis and Kjell-Olof Feldt were instrumental. In sum, individual initiatives have a significant influence on large structural changes in the financial system and on shifts between regulatory regimes.

Successful Future Regulations Are Likely to Be Multidimensional

The Statist Regime relied heavily on direction from higher authorities. In contrast, during the Market Regime, banking was guided primarily by traditional bank legislation (see the presentation in Chap. 2); because this legislation was not especially detailed, self-regulation became more important. The financial sector's interest in risk management intensified during the turbulent 1970s. In the 1980s, a series of new statistical models to assess risks were developed and risk management departments were created. Central banks were expected to use the interest rate as a tool to regulate financial activity as part of a hands-off approach.¹ These two approaches, direction from authorities and self-regulation,

were viewed as substitutes, but a lesson from the past suggests that they should be viewed as complementary. Below, we expound on this notion from the perspective of the Basel III regulations.

The Basel regulatory framework was developed in tandem with the internal development of risk management in the banking sector and evolved to become the key regulatory framework of the Market Regime. The Basel framework considerably broadened the concept of regulation by adding several different dimensions. In the words of David Llewellyn, “Just as the causes of banking crises are multidimensional, so the principles of an effective regime for financial stability need to incorporate a wider range of issues than externally imposed rules on bank behavior.”² Llewellyn has developed a schemata of financial regulatory regimes based on various components that regulate the relationship between the government and actors in the financial market. These components can be grouped into the following categories:

Governmental activities

Rules established by regulatory agencies.

Supervision by official agencies.

Intervention protocols in the event of failure.

Market activities

The role of market discipline and monitoring.

Internal corporate governance within financial companies.

Activities combining governmental and market activities

Incentive structures established by regulatory agencies, consumers, and banks.³

This perspective stresses that direct regulation can be a complement to and not merely a substitute for market discipline and that both might be necessary. Llewellyn strongly emphasizes the importance of interaction among the official regulator, financial organizations, and consumers of financial products for the creation of an effective financial system.⁴

From a broad perspective, the Riksbank regulatory period is a good example of *governmental activities*, especially through the establishment of detailed regulations. The increase in direct rules had consequences for supervision. Specifically, although the Bank Inspection Board (*Bankinspektionen*) was formally responsible for ensuring that banks adhered to the applicable legislation in the period 1950–1985, it had no control of the Riksbank regulation. Rather, the Riksbank regulation was handled by the Riksbank through monthly reports and meetings, which implied a more active role for the Riksbank compared to that of the Bank Inspection Board. Consequently, the banks (and the insurance companies) had to be more rigorous and detailed in their statements to the Riksbank. Thus, in effect, the Riksbank performed a supervisory function.

The Riksbank's control of the financial companies also encouraged a special form of self-regulation: cooperation among banks. For example, interest rates for both deposits and lending were coordinated by the banks through meetings; when the banks had agreed on the new interest rates, they were jointly published in daily newspapers. The Riksbank regulation, which established maximum and minimum interest rates, was the basis for the banks' coordination of interest rates. Adherence to other regulations (for example, liquidity quotas) was also accomplished through coordination and discussions among the banks.

Regulations Can Have Different Purposes

As discussed in the first chapter, regulation of the financial sector began early and was motivated by the emergence of problems related to consumer protection and financial stability. Regulation was hence not part of a particular political agenda. This is an important lesson: regardless of the political views of a particular government, some form of financial regulation is likely necessary to protect the consumers of financial products and to maintain financial stability. However, following World War II, financial regulation clearly was used as a tool for fulfilling particular political goals in addition to providing consumer protection and financial stability.

In Sweden, the Riksbank regulation created in 1951 was clearly linked to the Social Democratic postwar program. Financial stability was obviously an important concern, but the regulation went much further. Specifically, they were developed to handle what the government viewed as an imbalance in the market: demand for capital in prioritized sectors was higher than supply, and a free market for capital would make it difficult for the government to fulfill its political goals. The Riksbank regulation thus differed fundamentally from the bank legislation and regulations established toward the end of the nineteenth and beginning of the twentieth centuries. We would argue that these earlier laws were pragmatically created to increase systemic stability; by contrast, the bulk of the postwar regulations were aimed at stimulating the economy and channeling capital to sectors deemed important. It is therefore possible to be critical of the Riksbank regulation and its political motivations but nonetheless advocate ambitious regulations to ensure financial stability.

Regulations Can Negatively Affect Key Actors Even if Social Costs Are Low

From the perspective of the Social Democratic ideology, the restrictions imposed on the financial market were largely successful. Moreover, they do not seem to have been particularly costly for society as a whole, because the period of the Riksbank regulation was one of unprecedented financial stability and strong economic growth. The regulation did have direct economic consequences for market actors, however. For example, the liquidity quotas and lending ceilings prevented banks from being as active in industrial financing as they had been before World War II. However, whether the Riksbank regulation caused reduced profits for the banks is uncertain. The regulation of interest rates—through both the Riksbank regulation and agreements among the banks—reduced competition and made the market more oligopolistic, which likely increased banks' profits and counterbalanced the costs of the regulation.

Compared to the period before the Riksbank regulation, the ratio between total lending and total deposits was reduced from approximately 100% in 1950 to 75% in 1960. This reduction was considerable and probably hampered the development of industrial and trading companies. Nevertheless, the 1950s and 1960s were golden years for Swedish industry, with a growing international market and increased opportunities to use internal financing for the development of production and business. Thus, it appears that industrial companies managed to handle their finances through other means during the restrictive credit period.

In sum, regulations can damage the interests of key actors. Ultimately, it is a political decision whether these negative effects on key actors should be tolerated to achieve regulatory goals.

“Shadow Banking” Is a Real Concern for Regulation

The Riksbank regulation was constructed in the 1950s to ensure the regulatory compliance of banks and insurance companies. It was equally important that the regulatory system not be undermined by loopholes. The Riksbank regulation was initially a coherent control system, but the development of new financial companies and instruments made it possible to circumvent the regulations. An early example of this circumvention came in the mid-1950s, when banks established special financial companies to handle leasing and factoring, which were prohibited activities for banks under the legislation.

The development of the Euromarket also had a great impact on the Swedish postwar regulatory system. With the advent of the Euromarket, it became more difficult for Sweden to remain isolated. In 1969, under the leadership of Åsbrink, the Riksbank raised interest rates through the infamous “Kill Switch.” The use of the Kill Switch placed additional pressure on the strained Swedish financial system and on the fragile relationship between the Riksbank and the banks.

The 1970s and 1980s saw several innovations that the banks could use to circumvent the Riksbank regulation. For instance, bank certificates allowed banks to purchase bonds without formally violating the liquidity quotas. At the time, the Riksbank staff viewed the financial innovations as highly successful and believed that they rendered the Riksbank regulation useless to achieve their goals. In hindsight, however, considering the quick buildup of credit after deregulation, it seems that the efficiency of the loopholes was overestimated. Nonetheless, the loopholes likely had a psychological effect by undermining the regulators' confidence in the efficacy of their efforts. This lack of confidence eroded the commitment of the regulators and hence legitimized deregulation.

A Successful Macroeconomic Regime Can Become Obsolete

The Classical Regime, with its gold standard and central bank independence, was largely successful at the end of the nineteenth century in terms of achieving its purposes, which were to ensure price stability and a stable financial framework for trade and investment. However, this regime was unable to guarantee economic stability after World War I. Although the specific reasons for this failure continue to be debated, it seems fair to say that the main problem was that the world had changed since the Classical Regime was constructed.

Similarly, the Statist Regime was successful for a number of decades but came under increasing pressure toward the end of the 1960s. In the 1970s, the world was a different place from the one that existed when the Statist Regime was inaugurated. Attempts to build a stable international economy had been torn asunder by fundamental imbalances in the balance of payments between surplus and deficit countries. The credit policy of the 1970s should be seen as an ad hoc emergency trial-and-error strategy to address such imbalances. In Sweden, the goals established by the Social Democrats toward the end of World War II were fading from the public mind and from the party that initially

established them, in part because the acute problems that they were intended to address had to some degree been solved. The international climate was leaning toward deregulation to solve imbalances, and Sweden, which was facing a seemingly worse economic situation than comparative countries, was home to a new generation of politicians and officials, many of whom were trained in economics. Thus, the stage was set for deregulation and the introduction of the Market Regime.

Deregulation and the increased emphasis on market solutions made self-regulation more important and increased the roles of the banks' owners and managers. Organized risk management became more important as regulations were eliminated. At the same time, coordination among banks was abolished and the interest rate was set competitively. For a while, the Market Regime seemed as successful as its predecessors in their respective heydays. A reduction in macroeconomic fluctuations in the 1990s and the beginning of the 2000s led to the notion of the "Great Moderation," i.e., a new era of economic stability. This notion was brutally smashed by the global financial crisis that began in 2007.

Toward a New Macroeconomic Regime?

An important tendency in the regulatory system since the 1980s has been the homogenization of regulations and the neutralization of differences among actors from different countries in order to increase competition. However, the financial crisis of 2007–2008 and its aftermath have led to a renewed insistence on market regulation. Determining the appropriate content of the regulatory system has become a global issue. The activities of Basel III were largely a reaction to the problems encountered between 2008 and 2010 and resulted in a wave of new regulations. The banking sector has repeatedly argued that these regulations threaten to reduce the flexibility and efficiency of banks.

It is tempting to interpret these new regulations as a step toward a new macroeconomic regime, and we agree that there is a tendency toward more regulation and control imposed by governments, central banks, and supervisory agencies. Basel III was in many ways an attempt

to fine-tune the regulatory system by imposing a web of interconnecting regulations onto an increasingly hostile banking sector. However, this web of regulations has been designed to maintain the fundamentally market-oriented nature of the financial system. This effort thus harkens back to the 1970s, when authorities attempted to impose order on the financial system by increasing regulations instead of undertaking a more fundamental regime shift. It is too early to say whether the Basel III framework will be sufficient to prevent a future financial crisis or at least to ensure that a future crisis has only moderate costs. However, it is clear that we have not seen a major regime change because such a change would entail fundamental shifts in political ideology and the use of other regulatory measures. Moreover, the preceding financial crisis has largely failed to produce any major shift in economic theory that would legitimize a regime change. However, the Swedish financial system's close connections to the EU and the development of Basel III will determine the development of national regulations in the future.

A new major financial crisis might signal the end of the current macroeconomic regime, but it is unclear what would take its place. As discussed above, the Statist regulatory regime was largely functional for its purposes but was haphazardly constructed based on the blueprint of a war economy. The Statist regime relied on cumbersome personal meetings and external controls. It was also a one-dimensional regulatory system and consequently undermined itself by building up resistance not only among the banks but also within the responsible agency, the Riksbank. Moreover, the world is a much more complicated place than it was in the post-World War II period. New technology provides opportunities not only for new forms of banking but also for new types of regulations. So-called RegTech—regulatory technology—could potentially revolutionize the ways in which regulations will be implemented in the future.

This book focuses on how the banking sector and its regulation have developed over time and interact with many other factors. It ends in the same manner: by once again stating the need to see financial regulation as something that continually develops through trial and error. The future will tell whether the Basel III regulatory framework will stand the test of time. A study of the past, however, indicates that, ultimately, few things can stand the test of time.

Notes

1. Dionne, “Risk Management”.
2. Llewellyn, “Regulatory Regime and the New Base Capital Accord”, 327.
3. This distribution of governmental activities is based on Llewellyn, “Regulatory Regime for Financial Stability”.
4. Lewelly, “Regulatory Regime for Financial Stability”, 16–20.

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