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1. Introduction (AB-word-norm:400, currently: 569)

From the mid 80s to the early 90s Swedish policy makers confronted a great challenge in formulating appropriate policies towards a financial market undergoing rapid change. In hindsight the task can be described as trying to facilitate a smooth transition from a severely regulated and largely insulated credit-based financial system where innovation was mostly performed by the regulators, to a liberal, competitive and internationalised financial system where capital markets played a greater role and innovation was mostly performed by market actors.¹

Overseeing this process involved challenges at two levels of economic policy making. At the macro level the main challenge was to provide stable economic conditions. That is, to be able to co-ordinate functionally interdependent policies so that the total impact of policy on a financial market in rapid growth would be counter-cyclical or at least not violently pro-cyclical. Policies that had the potential to impact financial market developments in an unfortunate manner included tax policy, exchange rate policy and capital control policy. At the micro level the state’s tasks involved formulating appropriate prudency regulation and making sure that the surveillance apparatus was capable of handling rapidly growing financial institutions undergoing fast change.

In hindsight we can see that Swedish authorities, like many other in the 1980s, by and large failed in this. Instead of facilitating a smooth transition, policy contributed to asset price inflation leading to a speculative bubble forming in the markets for real estate and shares. When the bubble burst and these markets crashed, they took several banks and other financial institutions with them into a banking crisis of proportions only comparable to the great crisis of the 1920s. Losses on bad loans totalled 175 billion SEK for the four years from 1990 to 1993. This corresponds to about 12 percent of GDP in one year. In the two worst years, 1992 and 1993, losses corresponded to 7 percent of the total stock of loans (Wallander 1994:73). No banks were allowed to close down, but the three biggest losers (in absolute and relative

¹ In his discussion of financial innovations and financial market development in Sweden from 1945 to 1990 Werin (1993:108) makes two observations of interest to this study. On the source of financial innovations he notes that from the 1940s through the 1960s the state is the most active party as it sought to develop new instruments of regulation. During the 1970s this picture gradually changed with market actors taking on a more dominant role. On the rate of innovation, he notes that this increases markedly during the same period.
terms) are no longer independent, but are parts of bigger concerns as a direct result of the crisis. The (swift, decisive and successful) rescue operation had a gross value of 68 billion SEK (Lindgren 1994:27). This corresponded to about 12 percent of the state’s budget for the fiscal year of 92-93, or about 5 percent of GDP. The net cost to the taxpayer (after the state had been able to sell off most the assets it acquired through its rescue operation) has been calculated to 35 bn. SEK (Jennergren and Näslund 1998).²

The rest of the paper is structured as follows: In section two I will introduce the main institutional actors that participated in the policy making of the boom and bust episode. In section three I will give a stylised description of Swedish monetary policy and credit market regulation in its broader political context before the transformation of the second half of the 1980s. Section 4 fleshes out the case. In subsection 4.1 the policies of boom are reviewed. Section 4.2 looks at the policies of bust, crash and rescue. Section 5 asks in what sense and to what degree it is meaningful to conceptualise great losses in primarily privately owned banks as a policy failure. After concluding that there is indeed a significant element of policy failure in this case, section 6 addresses the causes of this. Section seven concludes.

2. Main actors (AB-word-norm: 800, currently: 820)

The main argument underlying this analysis is that the contribution of politics to the Swedish banking crisis was a failure to co-ordinate functionally interdependent policies. This forces us to consider several aspects of economic policy that all impacted the Swedish banking crisis. The policies covered are credit-, interest rate- and capital controls, fiscal policy, tax policy (with special emphasis on the issue of interest rate deductions), exchange rate policy and prudency regulation and surveillance of the financial sector. The impact of incomes and fiscal policy will also be touched upon at some junctures. The main institutional actors in this story are, the central bank, Sveriges Riksbank, the supervisory body, Bankinspektionen (BI) ³, The Ministry of Finance (MF), (various) Government(s) and Parliament(s). Parliament is first and foremost and arena for party politics. I will however, also consider The social democratic party (SAP) and its link to LO (the Trade Union Confederation). The influence of institutional

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² The estimate for net costs to the tax payer is a modest one. Jennergren and Näslund (p. 75-76) stress two cost components they were unable to include in their calculations. One is that the banks in general raised their net interest margins in the crisis years (from a previous average of around five percent to more than six), the other is the transfer of wealth from the public at large to share holders of the banks that were able to survive because of the general guarantie issued by the authorities in 1992 (see section 4.2 below).

³ The responsibility for bank-supervision was transferred from Bankinspektionen to Finansinspektionen (FI) when the former was merged with two other regulatory bodies to form the latter in July 1991.
actors varies somewhat between issue areas. In this section I will introduce the main actors. I will also indicate in a rough manner within which issue areas the different actors were or could have been expected to have had most and least influence in the policy-making process in the period under study here.

The position of *Sveriges Riksbank*, the single most important institutional actor in this story, can be difficult to gauge. Acknowledged as the oldest central bank in the world (Deane and Pringle 1994:33) in constitutional terms it had, unlike most other countries, formal responsibility for both monetary and exchange rate policy (Wihlborg 1993:242). Still research on central bank autonomy has concluded that it was a highly dependent bank. This conclusion emerged after looking at indicators meant to capture its degree of insulation from political pressures. Indicators such as the conditions for the tenure of its governor (too short and too easy to terminate), the terms of the appointment of the members of its board (too political) and its stated goals (too ambiguous i.e. not enough emphasis on price stability). Even if this analysis is accurate, or maybe exactly because *Riksbanken* was not very independent in formulating monetary policy under the old regime, it had a strong motive for arguing in favour of liberalisation. A detailed historical investigation by the political scientist Torstein Svensson (1996:53-59) has shown that in the mid eighties, *Riksbanken* was the dominant actor in the politics of liberalisation. It possessed the only real group of experts within the issue area and its staff, rather than the politically appointed members of its board, took the important initiatives of the liberalisation process. At the same time it was less dominant, but still influential in the politically more visible issue of exchange rate policy. Prudency issues on the other hand, was primary the responsibility of *Bankinspektionen*.

In the whole period of primary concern here (1981-1993) Sweden has had minority governments from both sides of the social democratic/bourgeois divide. And the last majority government before this, the bourgeois coalition that came to power in 1976, was riddled with internal strife. Measured as a proportion of GDP Swedish public expenditure was (and still is) the most generous in Europe. From the mid 70s the state was burdened with persistent deficits and inflation rates above that of its competitors. By the early 80s, then, the Ministry of Finance was primarily concerned with finding ways of reducing the deficit, while it was less interested in credit policy (Svensson 1996:35-36).

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4 Reference to the standard works here + Skånland. Also mention that its status has changed in an adaption to the Maastricht-treaty, even though Sweden has so far not joined the EMU.
In the first 35 years of the post-war period LO, was a key actor in Swedish economic policy in general. Not least through its research department it enjoyed great influence on the hegemonic Social Democratic party (which ruled uninterrupted from 1932 to 1976). In incomes policy it was at least an equal partner to the interests of capital which were also centralised and well organised in the employers union (SAF). By the late 70’s this picture was changing. LO lost a lot of prestige and good-will in the fight over wage earner funds, and the Social Democratic party started to develop its own party-internal alternative expertise in economic policy (Pontusson 1994: 34).

In an analysis of why co-ordination fails, it is crucial to appreciate that different institutional actors play different roles in relation to different types of policy. While for instance policies of credit controls is seen as technically difficult with an arcane quality to it which all but reserves it for the technocratic sphere, interest rate deductions and tax levels engages the electorate directly and all the major parties has great stakes in it. To be crude we can imagine a continuum between these two extremes, where all the other issue areas have their place. Fiscal policy in general would be close to the “democratic politics” end of the spectrum. Prudency and supervisory policy would be close to the other end while exchange rate and incomes policy with its technical-corporative nature, fits in somewhere closer to the middle.

3. Political and institutional context (norm 800, currently 1007)

Before we turn to the dramatic events of the 80s and the early 90s it is useful to try and understand the credit management regime Sweden left when her financial markets were liberalised and internationalised. To better appreciate this regime and why it was abandoned it is also necessary to view it as a part of a broader macroeconomic regime and the troubles this regime ran into in the 1970s.

Swedish fiscal policy was fairly moderate, aiming at balanced budgets or small deficits. The significance of fiscal moderation for credit market regulation will be elaborated below. Incomes policy was conducted between LO and SAF with the state in a more withdrawn role compared to the role it was to play later. Incomes policy was “solidaristic”, in that it over time secured a relatively compressed wage structure, but even more important was

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5 The insight that policy can determine politics is an old one. An influential statement from the 1960s is Theodore Lowi’s (1964). For a more recent application of similar ideas see Pierson (1993, 1996).
the goal of keeping real wage increases within the limits set by the productivity growth of the export sector.

The role of credit policy in the Swedish economic strategy of the first post-war decades was at least fourfold. It supplied a counter-cyclical element that fiscal and incomes policy lacked, it sought to provide fairly low interest rates and it sought to privilege house construction and public borrowing. In order to achieve this the maximum rates charged by banks were defined by the authorities, and the released volume of credit was managed by an arsenal of credit controls that grew more complex and far reaching - in terms of the type of institutions covered - over time. The state also regulated the supply of, and demand for, bonds. In reality the use of this type of instrument was suppressed for any other purpose than those favoured by the state. Further, extensive capital controls were employed to shield the credit market, and to ease the strains on exchange-rate policy.

In executing credit policy, the central bank relied on a combination of bi-partite negotiations and "recommendations" and more direct regulations. Cash and liquidity requirements were used to regulate the liquidity of the banks. For periods of very strong credit demand the Riksbank in 1955 introduced a more direct type of regulation. It was a “ceiling” on what it called "other lending" (i.e., lending apart from to the construction of homes (Jonung 1993:299). Home construction was also subsidised directly. From the mid-fifties and onwards Swedish tax revenues began to increase faster than the OECD-average (Steinmo 1993:132). This was reflected in high and increasing marginal rates. The system also allowed deducting interest payment from income tax. This brought real post-tax rates downwards and it reduced the real progression of the tax system.

In the 1970's Sweden went from moderate to unsustainable fiscal policies. The background was the twin external shocks of the breakdown of the Bretton Woods currency regime and "OPEC 1" in 1973. The ensuing international recession was met with expansionary monetary and fiscal policies. The defensive industrial policy continued and the budget deficit increased when Sweden got a bourgeois coalition government after the 1976 elections.

The Swedish state also engaged itself more directly in incomes policy. The government contributed with tax relief and increased transfers thus further weakening its fiscal position. This was supposedly done in exchange for moderation. In reality the "Haga-agreements" resulted in unprecedented growth of real wages (Mjøset 1987:423).
Why then, were the deficits and the inflation of the mid 1970s detrimental to the credit market regime that came to be abolished roughly 10 years later? At least four mechanisms can be identified: The first mechanism works through the money supply. When the authorities based their regulation of credit supply (and ultimately its effect on aggregate demand) on bank and other forms of institutional lending, they were in effect taking other factors that influence the money supply as given. In other words, for credit controls to work efficiently its a great advantage, if not a necessary condition, that other factors that influence the money supply shows a stable pattern. If not "credit demand" is much harder to predict and hence it gets more difficult to plan credit policy. More importantly, persistent deficits injected more liquidity into the system, liquidity that could fuel unregulated "grey" markets.6

The second mechanism was intimately related to the first. While the monetary growth created by the budget deficits contributed to the supply of grey credit, falling post-tax real interest rates fuelled demand. Falling real rates was a general European experience but the above OECD-average marginal tax-rates made the trend particularly powerful in Sweden. This was because a system of credit controls does not totally supplant the price mechanism, it modifies it. That means that, other things being equal, it is harder for controls to work efficiently the further you move away from an equilibrium price in the market. Rising inflation in the mid to late 1970s dragged real post-tax rates down both as a direct effect, and indirectly through so-called bracket-creep.7

The third and fourth mechanisms were both effects of government debt accumulated during the years of fiscal excess. Firstly, when seeking holders of its increasing debt burden, the Government needed to court new investors outside its (partially forced) traditional market made up of financial institutions. The new investors would be households and non-financial business entities. To attract these, new instruments were created (Jonung 1993:332), producing a two-price system. Market price was used to court new investors while vis-à-vis the banks the authorities could use regulatory instruments to make sure their paper was accepted at a lower price. The two-price system induced arbitrage and evasive actions from

6 In "grey" markets, transactions are conducted directly between non-institutional lenders and borrowers, but where the finance-institutions often continue to play a defacto role as an intermediate, for instance by underwriting the transaction.

7 Bracket creep is a term used to describe the process whereby inflation intereracts with a progressiv system of taxation so that lower to middle incomes gets increasingly higher marginal taxes. This happens when the authorities fail to adjust tresholds in the tax system quickly enough keep pace with (wage)inflation. Other things equal this type of process when allowed to happen increases total government revenue from direct taxation.
the banks, while the new instruments were like ready made for traditional market conform regulation (open market operations), the orthodox alternative to credit controls. The fourth mechanism that connected fiscal deficits with pressure on the credit market model also had to do with the need to attract capital. Borrowing abroad from around 1975, and later wanting the private sector to do so, the Swedish state was forced to contribute to capital market integration that in the longer term reduced her monetary autonomy.

4. The case (norm: 4000, currently: 5543)

This section of the paper is divided into two main parts: In section 4.1 I consider the policies pursued and the market developments of the boom phase. In section 4.2 I describe policy and market movements in the phase that saw bust, crash and rescue

4.1 The boom phase

In the elections of 1982 both the SAP and their allies to the left (VPK) did reasonably well and the Social Democrats returned to power to form a relatively strong minority government. The challenges they faced were formidable. Unemployment and inflation had both increased under bourgeois rule, while they also inherited substantial fiscal and balance of payment deficits. The Government decided to make an offensive devaluation, a “big bang” (16 percent, coming on the heels of a 10 percent devaluation the year before) was the centrepiece of their new strategy. The hope was to kick-start the economy through a profit-driven boom in the export sector. This was to be followed up by a commitment to a fixed exchange rate (against a “basket” of currencies Sweden had used since leaving the snake in 1977), more energetic incomes policies and fiscal moderation, all with the overriding goal of containing inflation. The strategy was dubbed the “third road”. This alternative reflected the ascendancy of the new Minister of Finance, Kjell-Olof Feldt and his circle (Bergström 1991: 280-298). At the same time the economists of the LO lost influence on policy making (Pontusson 1994: 34). This made it easier for the SAP to move towards neo-liberal ideas.

Immediately after the new government took office in October 1982, a report on credit policy commissioned by the outgoing non-socialist government, was delivered. The report highlighted the disadvantages of a highly regulated market and recommended that day to day management of credit policy should be more market conform. Still it opened up for retaining a core of credit and interest rate controls in line with its general conclusion that a “pure” liberal market order was not realistic in Sweden (SOU 1982:10). According to the chairman of the
committee, the private banker Jan Wallander, this modification was hooked on towards the end of the analysis to make the report less controversial in social democratic circles (Svensson 1996:41).

It should be noted, however, that credit policy (understood as credit and interest rate controls) played no real part in the third road strategy. Erik Åsbrink, at the time under-secretary at the Ministry of finance and a key advisor to Feldt, is quite blunt. “This (i.e. credit policy) was not a major issue for the incoming government” (Svensson 1996:35-36). The post-devaluation economic policy discourse of social democracy was centred on the exchange rate commitment, the problem of persistent budget deficits and incomes policy (Wihlborg 1993:237). This relative negligence created more room for the central bank. According to both Jonung (1993) and Svensson (1996), the central bank took a leading role in the process. It wanted to do away with a multipurpose system of regulation, that it felt contained too many internal contradictions. The growth of grey markets and the inflationary pressures this yielded was a key factor in convincing the Riksbank that credit controls could not work effectively. The fact that increasing efforts at regulation were continually circumvented constituted a learning process for central bankers. From these lessons, the central bankers concluded that grey markets needed to be wiped out in order to control inflation. To dispense with the grey markets, central banks needed to be able to utilise the price mechanism in a uniform manner across different segments of the market.

First, liquidity quotas were repealed upon initiative from the Riksbank in September 1983. This was mainly argued for by reference to problems of a technical nature, that in short were created by the state’s need to finance its budget deficit. It had also been recommended in the report published the year before. The core of the model, interest rate and credit controls, however, survived another two years. During this time - and while continuing to utilise the regulations still available, the staff at the Riksbank continued to work for the abolishment of this core as well, being able to refer to the arguments presented in the report of 1982 (Svensson 1996: 78-79, Wohlin 1998: 24).

Then in May 1985 interest rate controls were scrapped. The immediate background was balance of payments problems that need to be warded off by higher interest rates. At the same time the credit ceiling was lowered (i.e. banks were given less room for expansion), and

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8 After the change of governement Conservative minority members of the Riksbank board also took the opportunity every autumn (as next years round of regulations were prepared) to proclaim a more general critique of the regulatory regime, again with references to the report of 1982 (Svensson 1996: 44 ).
in general the credit policy of the 1982-85 period can be characterised as a non-linear process: On some occasions regulations were made loser, on other they were tightened. On November 21, however, when the *Riksbank* board decided to scrap the ceiling on new lending, the decision on interest rate controls as well as the earlier decision on liquidity quotas were presented to parliament as sequences in a chain leading up to a more market conform regulatory model. The main argument was that the old regulatory devices were inefficient. If anything they mostly contributed to perverting competition and suboptimal allocation (Svensson 1996:80). It follows logically that if the old regulatory tools were inefficient, the scrapping of them would not be of great consequence. As we shall see below, later developments proved this understanding to be faulty. The events of this autumn have even been called the “November revolution”. But at the time liberalisation was sold as a technical and not a dramatic decision.

One individual who did not subscribe to this view was Lars Wohlin. A former central bank governor and in 1985 CEO at Sweden’s largest mortgage company, *Stadshypotek*. Upon being informed of the *Riksbank*’s decision, he immediately ordered his organisation to offer as many new bonds in the market as possible to be able to meet the increased demand for credit that he foresaw. Between one and three o’clock on the 21. of November *Stadshypotek* issued for 300 million SEK, a substantial amount for one institution in two hours. In December the monthly growth rate for credits from *Stadshypotek* quadrupled (Wohlin 1998:21). Based on the assumption that property prices would rise faster Wohlin also ordered that his institution move its upper limit from providing 75% to 85% of any mortgage objects value. Other institutions sooner or later did more or less the same. The aggregated result was a phenomenal growth period that may well be classified as a credit explosion. If we look at lending to households and businesses together the average rate of increase (in nominal terms) was 62 bn. SEK for the 1980-85 period. The average for the next 5 years was 207 bn. SEK.⁹ This corresponded to a doubling of the stock of loans (Lybeck 1992:64).

### 4.1.1 Asset price inflation

There are many reasons why credit growth of the size Sweden went through in the latter half of the 80s is problematic from an economic management perspective. It was inflationary through stimulating demand, it put pressure on the administrative capacity of...
banks to handle risk at both the level of the individual credit and at the portfolio level, and it seriously destabilised the real economy through interaction with assets markets in driving asset price inflation into a speculative bubble.

The dynamic behind asset price inflation and bubble formation is simple: When the assets most commonly used as collateral for bank loans - shares and real estate - goes through rapid price increases this can set off a spiral type movement. Rising prices of collateral provides a rationale for extending credits which in turn fuels inflation in these markets and so on and so forth. Rising prices creates optimism which feeds on itself. Owners of assets can increase their borrowing against objects they already posses and increase their consumption. Or they can invest in more expensive assets, based on an implicit assumption by both bank and customer that the price of the object in question will continue to rise. The problem is that asset price inflation fed by unrealistic expectations rather than underlying value creates a house of cards like structure once market sentiment turns. In a highly illustrative piece of graphics present central bank governor Urban Bäckström (1998:11) shows that growth in the stock of loans and an index for assets prices followed each other closely from 1970 till 1990, with both lines moving steeply upwards after 1985, before assets prices fell sharply in 1990. The curve for loans followed suit with a time lag. Below I will argue that both the real estate and the stock market was, for different reasons, ready to engage the credit market in a process of asset price inflation as soon as the credit ceiling was lifted.

The most important market for this analysis is real estate because around 50 percent of the later losses experienced by banks was related to this market (Berglöf and Sjögren 1995: 33). On the whole it is correct to say that real estate took off in the aftermath of the 1985 decision to scrap the credit ceiling. Commercial property however, entered the 1985-89 period at a high speed riding on a corporate profits boom created by the 1982 devaluation. From 1982 to 85 prices for commercial real estate grew by a factor of three. From 1985 to 1989 this market picked up even more pace, as these years saw a further quintupling of prices - another way of saying this is that on an index where 1980=100, 1989 was 1500! Prices for residential property grew fast as well, but not that fast, with the1989 index value ending up at between

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10 The indicator for assets prices is a weighted index of real estate and share prices.

11 This time lag is attributable to the difference between using a stock measurement as opposed to a flow measurement (yearly change). The relevant flow measure (net supply of credit from the banks) turned negative in 1991 and remained so through 1993. But it took a few years of negative credit supply before the stock was “visibly” reduced.
200 and 500 depending on the category one looks at, with most of the increase coming after 1985 (Lybeck 1992:63-64).

The reason Wohlin himself gives for correctly predicting the phenomenal increase in the demand for credit from the real estate sector, is that several decades of regulation had opened up a gap between the potential collateral value of Swedish real estate and the actual degree to which it was mortgaged. This is because in market regulated like the Swedish the degree of mortgaging reflects historical building costs. Swedish regulations favoured housing (and real estate) construction in general, not purchases in the second hand market. Historical building costs will over time fall as a fraction of resale value even in a market with moderately rising prices. Wohlin (1998: 25) points out that in 1985 the total stock of real estate in Sweden tied up around 40 percent of the total stock of loans in the economy. In the UK market which had been liberalised earlier, the corresponding figure was around 70 percent. This figure roughly reflects the real estate sectors percentage of total real capital in a modern economy, according to Wohlin. The rapidly increasing prices, together with tax incentives and subsidies (see below) also produced a boom in the construction of new buildings.\textsuperscript{12} Fast paced growth also helped drive up costs in the sector, not the least labour costs (Pettersson 1993:28).

The stock market is not of the same direct importance to the crisis as the market for real estate. This is because lending to the stock market was not the source of large losses when prices fell in 1989/90. Still, the indirect effect is not unimportant: A stock market undergoing hypergrowth added fuel to the fire that overheated the Swedish economy in the last half of the 1980s. Like the market for commercial real estate our story of the stock market also begins in 1982. The primary effect the in-coming Palme-government hoped to achieve through its massive devaluation that year was a profit-led boom in the export sector. That they succeed in this is reflected in stock prices as well as in profits. From October 1982 to October 1983 an average portfolio at the Stockholm market rose by 90 percent. In 1984 the market did take a small breather as prices evened out, but credit growth soon got it under way again. The crash of 1987 in the world’s major markets does not even appear as a blip on the yearly figures. In real terms the market grew at a rate of 24 percent per year during the 1980s, which made it

\textsuperscript{12} Numbers for new units in this sector reflect decisions with a time-lag. 1986 was bottom year of the decade in terms of completed apartments. That year 29 000 apartments were completed. At the peak in 1991 the number was 66 000.
one of the fastest growing markets in the industrialised world during this decade (Lybeck 1992:64).

Another indicator that express the euphoria of the Swedish economy after devaluation and credit liberalisation is the savings rate. This had been stable at around 4 percent for much of the post-war period. During the early eighties it was reduced and after deregulation it went into negative figures. The “worst” years being 1987-89 when it averaged minus 4.3%. In a Nordic comparative study of the relationship between savings rates and prices in the market for residential housing, Eika and Nymoen (1992) concludes that credit market liberalisation triggered price increases which in turn induced behavioural change in terms of saving. In five years of boom private sector debt shot up from a 100 percent to 150 percent of GDP. (Bäckström 1998:11). A corollary to the fall in the saving rate was a rapid growth in private consumption. Also, the Swedish competitive position started to deteriorate as wage increases and consumer price inflation remained at a higher level than in the countries Sweden stabilised its currency against - the so-called basket-countries (Whilborg 1993:215 figure 10.1).

**4.1.2 Full speed ahead, but no brakes**

One of the men asked to report on the Swedish banking crisis, the economic historian Håkan Lindgren (1994:24), divides the history of the Swedish economy of the 1980s into two phases. Between 1981 (the year of the first devaluation) and 1985 growth was export-driven benefitting from the fact that the devaluations were followed by an upturn in the world economy. After 1985 the international upturn continued, but now domestic demand took over as the prime engine of growth gradually leading to an overheating of the economy. The story of asset price inflation told above basically conveys the same message. One important question that arises then, is, what was done to cool off the economy? The short answer is not very much. The general picture is that other policies that are functionally interdependent with credit policies were maladjusted to the credit-led boom. And when policies finally were changed, it was a case of too much too late, which is the topic of subsection 4.2.

The first policy area we should consider here is tax policy, or more specifically, the elements of the tax system that created incentives affecting credit market behaviour and the real return on different types of assets. The single most important element here was the right

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13 See Petterson (1993:43-59) for a very useful and fairly detailed discussion of the relationship between Swedish tax policies and credit demand in the 1980s.
to deduct interest payments from taxable income. In a country with high marginal taxes this could translate into a substantial gap between post and pre-tax real interest rates. The tax system also contained several other provisions, simple and complicated, that opened up a large room for arbitrage and tax motivated investment choices. This held for both households and companies. These provisions constituted a structural bias in the Swedish economy: They heavily rewarded loan-financed investments compared to using savings and retained profits.\textsuperscript{14} With the benefit of hindsight it thus seems obvious that repealing quantitative restrictions on the volume of credit without substantially reforming the tax system could release a powerful demand for credit. Petterson (1993:58) concludes that a major structural cause behind the Swedish banking crisis was that the tax system partly promoted borrowing for investments that with a more neutral system would not have taken place, and partly inflated the price and/or volume of otherwise sensible transactions.

In the late 1970s, after inflation and bracket creep had had its effect over a period of time, a realisation spread among policy making elites that the tax system needed reform (Steinmo 1993:182). In line with the kind of neo-liberal supply side arguments that were in the ascendancy internationally at this time, high marginal rates were held to produce growth stultifying incentives, while the numerous provisions were said to distort investment activity. Since the most financially resourceful in general are better at making a complicated tax system work to their advantage, it also became increasingly difficult to defend the system as neither reasonable nor fair.

The non-socialist coalition government(s) that ruled from 1976 to 1982 found it very difficult to move from a common understanding that something should be done, to actually doing anything. In Steinmo’s (1993:183) crisp phrase:

To oversimplify a bit: the Center party…wanted consumption taxes cut. The Liberal party wanted middle-class and salaried employees’ taxes cut. The Moderate party wanted to cut taxes paid by high income earners.

According to Steinmo the Social Democrats used this split among the governing parties to drive a wedge between them. They offered a compromise that entailed reducing marginal rates in exchange for putting a moderate cap on interest rate deductibility. The Conservatives (the Moderate party) who opposed any such cap eventually left the Government in protest, and thus the scene was set for SAP’s victory at the 1982 election.

\textsuperscript{14} An 8-country OECD study from 1987 concluded that in terms of its corporate tax system Sweden had the greatest tax wedges of all the cases compared. (Quoted in Petterson 1993:56).
The night the tax compromise was latter dubbed *underbara natten* (the wonderful night) but in reality the compromise was more of a paint job than a substantial reworking. Most of the incentives inviting loan financed portfolio investments were kept, and although the cap on deductions was gradually raised so that in 1985 a household could deduct maximum 50 percent of its interest rate payments, the system still encouraged (over)investment in real estate. During the latter part of the 80s a substantial group qualified for the 50% provision, which in reality made a nominal interest rate of for instance 10% bite as if it had been 5%.

On top of this came two other factors that increased the gap between the central bank’s main tool - nominal interest rates - and the real cost faced by borrowers - real post tax interest rates. The first of this is inflation. During the 70s Sweden built up a reputation as an inflationary economy and the country lived up to this in the 80s too. Entering the decade at a level around 14 percent, inflation fell towards the 5 percent mark in the middle of the decade before picking up again in 1987-90. In 1990 Sweden again saw double digits, just passing the 10 percent mark. In interplay with the tax system this had severe impact on the real post tax rates faced by normal income households. The perverse logic being that the more the economy boomed, the more inflation rose and the less it cost to borrow money (given stable nominal rates and deductibility rules). For mortgage loans for middle income families the real post-tax rate went below zero in 1987 to around two percent in 1990.

Management through the nominal rate of interest also proved to be problematic. In a globalising economy with a high degree of capital mobility the choice is often couched in terms of domestic (counter-cyclical) management of the business cycle versus exchange rate objectives. If a country, like Sweden, tries to combine a previously established fixed exchange rate target with a liberalised credit market, it can only expect that exchange rate imperatives and considerations for the domestic business cycle will match each other sporadically. In the aftermath of liberalisation Sweden repeatedly encountered problems of this nature. Exchange rate considerations dictated that interest rates would be either too low or too high compared to would constitute a sensible counter-cyclical use of monetary policy. In the first years after

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15 Swedish inflation figures are depicted in SOU 1996:205, figure 8.2.
16 Petterson 1993:50, figure 3.1.
liberalisation downward pressure on interest rates was a recurring problem because of capital inflows.\footnote{That there exists a trade off between monetary autonomy and fixed exchange rates in a world of mobile capital has become a standard topic in the international political economy literature. It has been conceptualised amongst others by (Cohen 1993) as the unholy trinity.}

About the same time as Sweden removed the credit ceiling in November 1985, the oil price came under serious pressure. That winter it collapsed and fell from just below 30 $ per barrel to around 10 $ per barrel. This provided a boost to the oil-importing advanced industrial states. Global interest rates fell and Swedish rates followed suit to the tune of 4 percent points (from around 14 percent to around 10, Jonung 1993:313), just as credit demand started to boom. Exchange rate initiated problems for monetary policy were compounded by the fall of the dollar (which was disproportionally represented in Sweden’s trade indexed basket) as the US currency depreciated violently in 1985 and 1986. Upward pressure on the currency also made it easier to fuel post liberalisation growth with foreign funds. As long as SEK was considered “safe”, Swedish companies with incomes in SEK, could borrow in currency at lower foreign rates. In general Swedish interest rates were a bit higher than those of its trading partners after liberalisation. Still they were no way high enough to ward off the credit led boom that was also being fuelled by tax rules and a comparatively high rate of inflation.

\textbf{4.1.3 Prudency - not adapting to a changing environment}

The main contribution of policy to the banking crisis is to be found in the mistakes of macro economic management and regulation reviewed above. Still, practices and developments at the level of prudency related policies did not help things either. At the this level the most significant trait is a lack of awareness that a liberalised, fast growing credit market demands a more stringent measures to counter-act increased risk taking. I will here briefly address two aspects of prudency policy: Capital adequacy requirements and the resources allocated to supervision of the credit market.

In 1993 Sweden fully implemented the modernised capital adequacy requirements that emanated from processes in the Bank for International Settlements (BIS) and the EC.\footnote{In the early 80’s US banks’ losses on third world debt had US authorities worried about the stability of their domestic banking system. At the same time “the international club of central bankers”, the Bank of International Settlements (BIS) were developing an interest in how much capital adequacy requirements diverged across leading economies and problems in security and competition this might lead to. While in Brussels, the EC was looking to develop a legal framework for their internal market for capital, which was a central part of the 1992-project. Ethan Kapstein (1992, 1994) has mapped and analysed these developments in a thorough and impressive manner.} Capital
adequacy requirements (a ratio of equity to total assets) is meant to secure that banks have a buffer of own funds that can be posted against losses before the funds of depositors and other lenders to the bank come into play. Such requirements normally include a provision for risk weighting. The logic being that there is less need to buffer against loans that go to low risk projects.

Compared to the new standards the old Swedish regime was more lax on at least two key points. The first of these points concerned the weighting of loans to homes. In the old Swedish system such loans were most often placed within a category that carried a capital requirement of 1 percent. The corresponding figure in the new international standards are 4 percent (Lybeck 1992:227, Wallander 1994:129). Of perhaps even greater importance was that the old system did not calculate capital ratios at a consolidated basis. This produced an incentive for banks to off-load large portfolios in fully owned mortgage houses (who had a general requirement of 2 percent, while the bank only needed a 8 percent coverage for its share capital in the mortgage house). This meant that if such a mortgage house increased its lending with one billion and its capital base correspondingly with 2 percent of 1 billion, the bank only needed to increase its own capital base with 1.6 million. (8 percent of 2 percent of 1 billion) (Wohlin 1998:26).

Such provisions meant that Swedish banks directly and indirectly could expand in the market for home financing with less concern for their capital base than what they would have been able to had capital adequacy standards been changed before rather than after the market was liberalised. This is important because so much of the eventual losses were related to the property sector and because stricter regulations would have made it impossible for the market to grow so fast in the first place.

The second respect in which the old standards were more lax than the new ones where in regard to subordinated loan capital. This is an instrument that enjoys a legal status between equity (share capital and retained profits) and ordinary loan capital. In case the bank should fail it is subordinate to ordinary loans, but it is privileged compared to share capital. Also, it cannot be written off against losses while the bank remains in operation. All this makes subordinated loan capital clearly inferior to “real equity” as a buffer against losses. For this reason the new international standards only allow up to 50 percent of a bank’s own funds to be covered by this type of capital. This rule is meant to be absolute. In the old days however, the practice had been to make the system more lax every time the situation demanded it. As Wallander (1994:136) puts it:
A bank’s ability to expand was not regulated by its ability to accumulate or raise (own) funds. Rather, the need to expand governed the definition of adequate capital.\footnote{My translation.}

Any major banking crisis will invariably lead to some critical attention towards the action (and non-action) of supervisory authority. It seems unreasonable to assume that it is within the powers of supervisory authority to prevent a banking crisis from happening, but some preventive effect can be hoped for through discovering problems early and generally seeing to that proper craftsmanship is being exercised. The resources allocated to supervisory activities can also serve as an indicator to how seriously the degree of change undergone by the financial sector is taken.

Sjöberg\’ (1994: 181-213) looks among other things at the resource situation of Bankinspektionen. The key point seems to be that while the tasks of the institution grew in volume and complexity, new resources were hard to come by. In their budget for 1986-87 the supervisory body calculated that with the same staff resources as in 1970, its workload was doubled. These sort of constraints obviously forced its leadership to make some tough choices, and it is Sjöberg\’s conclusion that these choices were not always wise. On the spot inspections for instance were reduced just as the banks started on their accelerated growth. In stead work related to new instruments (derivatives for example) and “new issues” (consumer protection and insider trading) was prioritised.\footnote{See also Engwall (1997:181).} One could say that the supervisory authority followed “newness” and innovation at the cost of not paying enough attention to the danger of in banking terms classic mistakes of poor credit judgement being repeated. Bankinspektionen is not, however, solely to blame for this according to Sjöberg (1994:212). He also criticises the Ministry of Finance for not formulating clear enough goals for the institution.

### 4.2 Too much too late: Bust, crash and rescue

After 9 good years the international business-cycle fell off in 1989 and turned to a recession in 1990. This happened in a situation where Sweden\’s competitive position had been deteriorating fast, particularly since the period of overheating began in earnest in 1987. The current account showed sizeable red figures by 1988 and in 1990 Sweden\’s competitive position was between 10 and 15 percent worse than before the great devaluation of 1982 (Wihlborg 1993:240). In May 1990 Sweden followed Norway\’s example from the year before and declared an uni-lateral link to the ecu. This meant throwing the US dollar out of the
basket, and as the dollar in this period swung wildly against the D-Mark, this made the ecu-basket less balanced than the old trade weighted one. It also meant that Sweden to a larger degree “imported” (rising) German interest rates (with a differential or premium) while it loosened its ties to US interest rates which were falling at this time.21

That German interest rates were going up was to a large degree down to the struggle between Bundesbank and the Kohl-administration over the financing of re-unification. This plus the uncertainty over Maastricht caused by Danish and French popular reaction to the treaty, and a falling dollar in the summer of 1992, put increasing pressure on the ERM. The troubles spilled over onto Sweden. In addition confidence in the SEK was particularly vulnerable to Finnish currency weakness since the two countries compete in price-sensitive export industries. In reality Finland devalued against the ecu in November 1991, while it gave up its linkage all together in September the next year. All this contributed to a prolonged period of high nominal rates at a time when the economy and in particular the financial market was in free fall and clearly in need of lower rates. Exchange rate troubles were also compounded by the fact that Sweden had scrapped its capital controls. This process ran from after internal deregulation was finalised in 1985. It was completed in line with the requirements of the Single market for capital and in time for that project's deadline in July 1990. Because of the need to finance budget deficits Sweden had for a while practised a fairly liberal policy on capital imports. With the new round of liberalisation it became legal for virtually anyone to speculate against their own currency for instance by borrowing at home and then taking this abroad to buy a more trusted currency. This sort of speculation is sensitive to extreme interest rate differentials. The Riksbank, with the full backing of its government decided to defend the currency at literally any cost. On several occasions during the 1990 to 1992 period the central bank drove short term rates to 40 percent or more, which contributed to persistent high money market and rates to consumers. The peak was reached in September 1992. For a short time overnight rates reached the incredible level of 500 percent.22

Also, tax reform was finally achieved in 1991. This reduced marginal rates to 30 percent, even for high income earners (Steinmo 1993:189). The effect of this, falling inflation

21 The arguments for choosing an ECU-link were first of all that it since it is an externally determined goal it might increase credibility and secondly the general optimism surrounding the EC at a time when the EMS looked like a great success, plans for the internal market were nearing completion and since the cold war was over, political elites in “neutral” Sweden were to an increasing degree orienting themselves towards Europe.

22 The then Governor of the Riksbank Bengt Dennis (1998) has published a book about these years entitled “500 %”.

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levels and an increasingly more desperate interest rate policy driven by exchange rate
imperatives was that the real post-tax interest rate rose steeply. Roughly speaking it went from
being marginally negative in the peak years and up to as much as the ten percent mark for
floating rate mortgages when the economy was in crisis in 1992. And the economy was in the
middle of a deep crisis at this point. The accumulated fall in GDP from the middle of 1991 to
the middle of 1993 was 6 percent (Bäckström 1998:11) Manufacturing output declined
dramatically while total employment fell by about 11 percent from 1990 to 1993 (Lindbeck

Actually, crisis signs in the financial sector began to show up as early as in 1990. That
autumn several finance companies encountered severe liquidity problems. These institutions
had specialised into transforming short term borrowing into long term lending to the real
estate sector, and when assets prices started to fall and the cost of short term finance went up
the squeeze was on. By 1991 these kinds of problems had spilled over to the banks. The logic
of asset price deflation was now playing itself out. Credit supply was negative. Financial
saving shot up from close to two-digit negative numbers to just above two digit positive
numbers in just three years, and real estate prices plummeted. There was a wave of
bankruptcies and the banks were caught directly through loans going bad at the same as the
value of their collateral fell short because of the fall in assets prices, and indirectly because
several of the banks had given credit to the finance companies that were now in deep trouble.

Although losses (as percentage of total stock of loans) varied greatly (between 9.5 and
37.3), all of Sweden’s seven biggest banks did experience severe losses in the 1990 to 1993
period (Wallander 1994:80). The stock of bad loans (loans that gave no or close to no income)
outsized the capital base of the Swedish banking system, and six of the seven banks needed
injections of fresh capital, either from the state or from their owners (which in several cases
amounted to the same thing) (Bäckström 1998:12).

In the autumn of 1992 it became clear that the crisis was of system-wide proportions,
and that the measures taken against it reflected this. The measures can be summarised in four
points.23

1) A general state guarantee issued in September 1992 which Parliament backed in December.
This said that the state would ultimately make sure that all liabilities (except share holder
capital) on Swedish banks (and certain other credit market institutions) were honoured on

23 This summary is based upon Söderström (1998:647) and Dokument 17 (257-261).
time. The state actually issued guarantees and interest free loans for two banks (*Första Sparbanken* and *Sparbanken Sverige*) (later *Första* was subsumed by Sparbanken), it provided a guarantee for *Föreningsbanken*, which was vital in securing new private capital, while *SE-Banken*, eventually managed to attract new private capital without any state-support apart from the positive effects of the general state guarantee.

2) The establishment in 1993 of a special body, *Bankstödnamden*, which had the task of securing the stability of the financial system through processing and handling any requests for state help to be able to meet capital adequacy requirements, and making sure that this help was given on equal terms.

3) The willingness to buy out private share holders in banks that could not secure enough capital to survive from their private owners. In one case the shares that were taken over were considered worthless (*Gota Bank*) while in another case, where private investors had been invited in by the state at a late date, these were fully compensated (*Nordbanken*).

4) The use of a “bad-bank” model. In the two cases listed under 3 above, this model was used to enable the “mother-bank” to continue day to day operations, while specialised organisations were established to concentrate on retrieving as much as possible from the bad loan portfolios.

5. *Assessment: Was this a policy failure? (norm:1000, currently: 1610 )*

   The task of assessing the degree to which the policy episode under study here represents a policy failure, will be broken down into four discussions. First we need to define a policy failure or fiasco: Second a qualification is in order: The banking crisis was not a policy failure in the sense that policy was the prime cause of events, rather we should speak of policy’s *contribution* to a complex causal picture. Given this qualification I will discuss to what degree the banking crisis reflected a programmatic failure, and to what degree it represented a wider political failure.

   Bovens and ‘tHart (1996:15) provide a good starting point for delimiting the class of phenomena that we can call policy fiascos with this definition:

   …a negative event that is perceived by a socially and politically significant group of people in the community to be at least partially caused by avoidable and blameworthy failures of public policymakers.
Bovens and ‘tHart identify four layers of meaning in fiasco construction. For our purposes three of these can be utilised as criteria for deciding whether “our” episode qualifies for the failure label. Briefly put, we can distinguish between the establishment of an outcome as a negative event, establishing a causal role for public policy in producing this event and that the political actions implicated by this understanding of causality were avoidable and therefore worthy of blame.24

That the banking crisis and the economic troubles it reflected was perceived as a crisis by significant social groups is beyond debate. I will also take as given the premise that the political actions that contributed to this were avoidable. In the next paragraph I will go some towards explaining why these blameworthy actions took place, but that is not the same as saying that these actions were pre-determined and unavoidable. The issue of the causal role of policy is, however, worth further reflection.

The starting point must be that whenever we make that the claim that policy failed, we implicitly invoke a particular causal understanding of the said events. In this particular case, the notion that policy contributed to, rather than drove events in a causally dominant sense, depends on the weight attached to a macro-oriented perspective relative to a more micro-oriented perspective when we want to explain behaviour in the period following liberalisation. A macro oriented understanding puts emphasis on policy. This is because policy sets the most important macroparameters for credit market developments. A premise for the discussion above has been that through controlling levers such as tax rules, the exchange rate and interest rates, the state creates an incentive structure which if perverse enough, can be said to have determined the unfortunate chain of events whereby Swedish markets for credit and assets first overextended then crashed. The alternative view is to place less emphasis on politically set parameters for action, and more emphasis on the choices made by the economic actors themselves. This paper has not explored such a choice oriented perspective wherein the bank-internal would be the most important. Still, it is possible to address three general arguments who all speak to the tension between these two perspectives.

24 Bovens and ‘tHart take what they themselves describe as a “moderate interpretivist” stance, which means - among other things - that a major ambition of theirs is to “deconstruct” policy fiascos as narratives. Their fourth layer of meaning in identifying a fiasco as a social construct is thus the process whereby blame is accrued; to analyse from a distance so to speak when the question “who is to blame for what” is being fought over. My ambition is more empirical, and I prefer to leave this phase (or “layer”) in the process that constitutes a fiasco out of the definition, and if anything let the answer be part of my results. I should also add that with an institutional approach like I have chosen here, where the perspective is that the political system as such has trouble handling complexity, the issue of identifying blameworthy actors looses some of its urgency.
The first argument is methodological in nature. It says that since Swedish banks displayed significant variation amongst themselves in the degree to which they overextended and then made losses, this indicates that there are limits to how far we can push an incentives based explanation: All the banks faced the same incentive structure in the shape of low real interest rates and customers eager to take advantage of a abundance of tax breaks and rising assets markets. Still, there was room for significant variation in how the banks reacted to these stimuli. A simple illustration of this point: The bank (among the big seven) that suffered the least losses (*Handelsbanken* - *around 10 percent*) roughly doubled its size in the 1980-89 period, while the bank with the heaviest losses (*Gota Bank* - *37 percent*) grew by a factor of 3.7 in the same period.

The second argument is complementary to this in that it provides substance to the room opened for exploration by the methodological observation above: A substantial body of research has showed that the banks changed their behaviour and attitude towards risk and risk management in the boom years. In hindsight one can observe behavioural traits - or bank-internal choices - developed in a manner contrary to the functional demands placed upon the banks by the new, more liberal environment. It seems difficult to link these behavioural developments to the incentive structure created by policy. Even if one did, they still reflect the kind of choices for which the banks themselves ultimately must accept responsibility. In general, but to differing degrees the banks increasingly tended to produce more sloppy work on the credit side, underestimate and underprice risk - particularly in borrowing to the real estate market (Petterson 1993:125, Wallander 1994:143, (Engwall 1997:191), increasingly less attention was paid to securing appropriate collateral (Larsson and Sjögren 1995:99, Engwall 1997:191) while there was an increased tendency to de-emphasise documentation and internal control as the banks grew (Engwall 1997:191).

A third argument that highlights the importance of not relying solely on a macro-perspective is the fact that the micro and macro-distinction is an analytical one that can only be upheld to a certain point. What I am thinking of here is that in times of extreme credit expansion it becomes particularly clear that bank choices in the aggregate at $T_0$ significantly shapes macro conditions within which banks act at $T_1$. In more concrete terms: The banks themselves helped create the climate of overheating which they in turn responded to as the process of asset price inflation ran its course.

These qualifications notwithstanding, there is still sufficient cause to label the Swedish banking crisis a policy failure. Attention to causal complexity is inherent in failure analysis.
Reading case stories on policy (and other types of crises and) fiascos it is striking how often they are accounted for in terms of series of counterfactuals of the “if only” kind. It seems that when we want to explain a positive human action it is often deemed sufficient to establish a plausible motive force. When we, one the other hand, want to explain why something bad was allowed to happen a much broader set of factors becomes potentially interesting. This point can benefit from an illustration: If an executive officer at a high level of a bureaucracy makes a discretionary judgement that has no consequences that are judged to be seriously negative, we have hardly got a research problem. At best such an event is explained with reference to cost-benefit calculations or norms of appropriateness applied within a framework that is given by the given bureaucracy’s repertoire of action and competencies. If, however, the decision, is judged to have had serious negative consequences, layers of new questions can be opened to investigation: Is the way information flows are organised faulty? Does the chosen action reflect limitations in the available repertoire, or does it reflect bad judgement from the person utilising it? In either case, could the incident have been stopped by superiors or other bodies with monitoring responsibilities? Is there a fault with the monitoring functions of this organisation? Or in the case of extremely poor judgement being shown, is something wrong with the recruitment and personnel policy of this organisation that hindered it in weeding out the individual in question at an earlier stage?

This is the typical for the anatomy of failure reconstruction. If a failure could have been averted or at least substantially modified at any one of these points in the causal chain, it means that any of these seemingly small events were necessary conditions for a fully fledged failure to occur.

In this light it seems fair to assess the events leading up to the Swedish banking crisis as a programmatic policy failure. If we express the substantive goal of the policy as that of overseeing and facilitating a smooth transition from a severely regulated and largely insulated credit-based financial system to a liberal, competitive and internationalised financial system we can conclude that this goal was not met. At a political level the answer is more complicated depending on how wide a perspective one takes. If we take the crisis as a given, and ask how the legitimacy of the regulatory system was affected by its ability to handle it, the answer is that the system enhanced its legitimacy. The management of the crisis was characterised by consensual, but realistic and effective reactions produced within a transparent process Söderström (1998:647). The crisis was over within 3-4 years of breaking
out. The Swedish banking system was back in good health by 1994-95, and has not been allowed to function as a long terms depressant as has been the case in for instance Japan.

In a broader context, that is to the degree that the crisis is seen as an expression of deeper ills within the Swedish political economy, the banking crisis has severely reduced the legitimacy of the system or “the Swedish model”. A substantial body of domestic and international neo-liberal research has contributed to an intellectual climate of self-flogging and self doubt in Sweden. In this view the banking crisis reflects a bloated public sector that in turn was related to crisis-inducing factors such as low productivity, high tax rates, budget deficits and inflation. To the degree that one subscribes to this analysis, Sweden has moved in the right direction, but the crisis is not over yet. Alternatively, if one attaches greater value to maintaining welfare state standards and keeping unemployment down, Sweden are also in trouble.

6. Analysis: Explaining failure (norm:750 currently 1278)

My strategy in this section is to seek to present rudiments of a theoretical argument that links regime change and likelihood of fiascos in macroeconomic and regulatory policy in the monetary sphere. The key point is that rapid and substantial change in some of the routinised policies that make up a policy regime can put insuperable pressure on the coordination capacity of the polity as a decision making system, and thus lead to a situation where policies are allowed to undermine each other. Utilising a vocabulary and a way of thinking which draws more on organisation theory than on political economy, we can say that this happens because policies that are tightly coupled in functional terms are only loosely coupled in the decision making process.

That functionally interdependent policies (policies that impact the same outcomes) are formulated in relative isolation from each other is an everyday fact of political life in advanced welfare states. This can be seen as a function of administrative and political imperatives. Thus loose coupling of, which implies selective and sequential attention accorded to, functionally interdependent policies, is not particularly interesting per se. What is interesting, however, is what can happen when loose coupling continues to be the procedure also in periods when core policies are changed. In such instances the case investigated here suggests that otherwise innocent looking sequencing and functional divisions of labour can

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25 Produce references at this point. e.g. Lindbeck-utredningen, SNS-forskning, some of Freemans work etc.
lead to a breakdown in co-ordination. That is to say, policies were set and policy changes were
temporally ordered without much regard for their interdependencies and this gave rise to a
situation where policies were allowed to work blatantly at cross purposes.

The approach put forward here rests on the general institutionalist supposition that
institutional orders (or regimes or policy models as they are called by different authors) can be
seen as alternating between periods of relative stability and periods with a high density of
change, the so-called “punctuated equilibrium metaphor” (Krasner 1984). This position must
in turn assume that any institutional order rests on a bed of functional compatibility between
its component policy routines. This is fundamental to how stability is implicitly understood in
large segments of the institutionalist and quasi-institutionalist literature on economic policy
making: If policies invariably have impacts outside their primary domain, a minimum level of
accommodation between policies must be built into the routines of the institutional orders. If
not, such regimes would not be able to endure over time, and a certain endurance is a quality
institutional orders have by definition.

I identify three sources of co-ordination breakdown in the form of what I call
disparate policy paths. I suggest this term to underline that I am not primarily interested in the
separate policy trajectories per se. I am interested in the relationship between them. That is to
ask, why was policy change and policy continuity so poorly mixed that it ultimately amounted
to a fiasco. These three sources of co-ordination failure I call asymmetrical degrees of
stickiness, selective learning and imported dynamics.

Asymmetrical degrees of stickiness refers to situations where the need for
accommodation may well be recognised by key actors, but where they are still not able to
apply this insight because some issues of reform are easier to push through than others. It is a
basic premise of my discussion that this in turn has to do with properties of the issue areas in
question. This type of dynamic is at the root of the problems of co-ordinating credit
liberalisation with tax incentives in particular, fiscal policy in general and incomes policy. It
was well understood by the decision makers that in order for a more liberal policy regarding
the right to lend and borrow to succeed, this depended on or at least would greatly benefit
from reducing tax incentives to borrow, and more restrictive fiscal and incomes policies. The
different political forces at work in these issue areas however made it relatively easy to do
away with credit controls, while tax, fiscal and incomes policies with more powerful societal
interests directly attached to them made them sticky.
Selective learning on the other hand refers to situations where functional interdependencies are not understood. In these instances the need for co-ordination in the shape of parallel adjustments of policies is not even perceived by the relevant actors. This concept directs our attention to those who did the intellectual ground work for liberalisation. Two characteristics of the learning process undergone by the economists that were entrusted to give advice on the liberalisation process, deserves special mention here. The first relates to the tendency of economists to reason within a comparative statics framework. By definition this kind of logic diverts attention away from medium term learning processes forced upon the market actors. The stylised juxtaposition of rival market equilibriums can give insight into many phenomena, but learning processes are not among them. Further, there was a tendency in the neo-liberal thinking that heavily influenced the reformers, to stress the advantages of a free market. Milton Friedman (1953) for example famously claimed that there is no such thing as destabilising speculation. Both these types of fallacy are present in the case at hand.

An instance of the first is how the credit explosion was interpreted at first. The Central bank had predicted that grey funds would return to the official balances of the banks, therefore it long insisted on treating credit growth as a statistical artefact rather than a real phenomenon (Svensson 1996:83-97). That there was real behavioural change, like the one predicted by Wohlin from his vantage point in a mortgage institute was not realised until the explosion was well under way. In general it seems that Swedish decision makers were unprepared for fast behavioural changes. Neither the sharp fall in the savings rate that accompanied the credit explosion, nor the sharp rise that came with and accentuated the crisis were expected. An example of underestimating the dangers of speculative behaviour is the fact that concepts such as asset price inflation and bubbles were not really on the agenda before it was too late. Arguably this is particularly noteworthy in a study of Sweden since ideas on the inherent instability of financial systems because of the dangers of unrestrained interaction between credit and assets markets were pioneered by the famous economist Knut Wicksell as early as in 1898 (Andvig 1991). The failure to give the supervisory authority sufficient resources and attention, also reflects a failure to appreciate the dangers associated with a liberal market.

Thirdly, when I speak of imported dynamics as a source of disparate policy paths I refer to situations where events outside the polity have substantial impacts on domestic policy co-ordination. This happens when external events contributes to change in one or more, but not all of a given set of functionally interdependent policy areas. A clear example is provided
by the case of exchange rate policies. In general there was a dilemma between the previously
established goal of a fixed exchange rate and the goal of managing a liberalised credit market
through active use of interest rates. This dilemma was made more acute by Sweden’s decision
to link up the ECU. This linkage implied an import of German interest rates when they were
on the increase, and an import of turbulence rather than the sought after credibility which
brought even higher interest rates, just as Swedish banks were running into trouble. The full
liberalisation of capital controls inspired by the Single Market and Sweden’s two-pronged
strategy to enter this (EEA and full membership) meant that the defence of exchange rate
came to be more expensive in terms of interest rates because it increased the potential for
speculation.

7. Conclusions (norm: 250 ord, currently: 0)

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