PALGRAVE STUDIES IN THE HISTORY OF FINANCE

Series Editors: D'Maris Coffman · Tony K. Moore
Martin Allen · Sophus Reinert

palgrave pivot

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

The study of the history of financial institutions, markets, instruments and concepts is vital if we are to understand the role played by finance today. At the same time, the methodologies developed by finance academics can provide a new perspective for historical studies. Palgrave Studies in the History of Finance is a multi-disciplinary effort to emphasise the role played by finance in the past, and what lessons historical experiences have for us. It presents original research, in both authored monographs and edited collections, from historians, finance academics and economists, as well as financial practitioners.

More information about this series at
http://www.springer.com/series/14583

Mats Larsson · Gabriel Söderberg

Finance and the Welfare State

Banking Development and Regulatory Principles in Sweden, 1900–2015

palgrave
macmillan

Mats Larsson
Department of Economic History
Uppsala University
Uppsala, Sweden

Gabriel Söderberg
Uppsala, Sweden

Palgrave Studies in the History of Finance
ISBN 978-3-319-61850-0 ISBN 978-3-319-61851-7 (eBook)
DOI 10.1007/978-3-319-61851-7

Library of Congress Control Number: 2017947164

Printed on acid-free paper

This Palgrave Macmillan imprint is published by Springer Nature
The registered company is Springer International Publishing AG
The registered company address is: Gewerbestrasse 11, 6330 Cham, Switzerland

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.

We wish to thank the financiers, HERA (Humanities in the European Research Area) for financing the UPIER project (Uses of the Past in International Economic Relations) and the Jan Wallanders and Tom Hedelius Foundations, as well as the Tore Browaldh Foundation in Sweden, for making this research possible. Our sincere thanks also go to Associate Professor Peter Hedberg at Uppsala University, who read the entire manuscript and provided helpful comments. Johan Molin, Eva Forssell, and Albina Soultanaeva at Sveriges Riksbank read parts of our manuscript and helped to save us from errors. In addition, we give warm thanks to Albina for giving Gabriel the opportunity to conduct research alongside Riksbank tasks. We are grateful to the anonymous readers from Palgrave Macmillan for their insightful comments. In the end, as always, any remaining errors are our own.

The project UPIER is financially supported by the HERA Joint Research Programme 3 Uses of the Past which is co-funded by AHRC, AKA, BMBF via DLR-PT, CAS, CNR, DASTI, ETAg, FWF, F.R.S. - FNRS, FWO, FCT, FNR, HAZU, IRC, LMT, MIZS, MINECO, NWO, NCN, RANNÍS, RCN, SNF, VIAA, and The European Commission through Horizon 2020.

This project has received funding from the European Union's Horizon 2020 research and innovation programme under grant agreement No 649307

Uppsala, Sweden

Mats Larsson
Gabriel Söderberg

Contents

List of Figures

List of Tables

1
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

M. Larsson and G. Söderberg, *Finance and the Welfare State*, Palgrave Studies in the History of Finance, DOI 10.1007/978-3-319-61851-7_1

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 Admanti 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 finds 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