

## Restructuring private debt: Sweden

### Abstract

*Dealing with a private debt overhang becomes a potentially important issue after a financial crisis. When economic growth slows and bank lending dries up, highly indebted households and companies may face pronounced difficulties. Sweden illustrates how to reduce private sector debt after a crisis. After the crisis in the early 1990s, the government not only revived the economy but also restored the health of household balance sheets. The ratio of debt to disposable income of Swedish households fell from 130 percent in 1988–89 to 90 percent in 1996. Interest payments were halved from 10 percent of disposable income in 1990 to 5 percent in 1997. The government kept the costs of the bailout low. By 1997, the total bill amounted to only 2 percent of GDP, due to comprehensive program that was tailored to different classes of financial institutions and realistic about financial sector losses. First, the government quickly recognized these losses. Transparency and true valuations were conditions for government support. Because banks were forced to write down losses, markets received accurate information. The government guaranteed their liabilities or took an ownership stake in the bank. By 1992, the Swedish authorities owned nearly a quarter of bank assets. Second, the government adopted an approach that was sensitive to distinctions among classes of financial institutions. Government assistance was available to not only Swedish banks but also foreign-owned subsidiaries in the country, as well as specific credit institutions. And the support's structure and amounts were tailored to the necessities of particular banks or institutions. A special body—the Bank Support Authority—was set up in 1993 to assess the magnitude of the troubled loans, as well as each bank's earning potential in the long run. The actions of the Swedish government show the potential for public policy to address the fallout of financial crisis, if implemented quickly with an honest recognition of financial sector losses.*

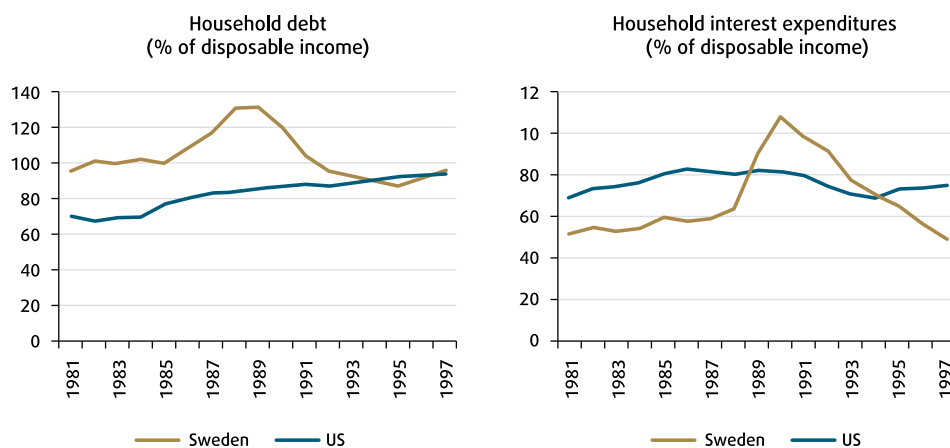
Private debt overhang can become a particularly important issue after a financial crisis. With slowing economic growth and reduced bank lending, highly indebted households and companies may face pronounced difficulties. Sweden can serve as a good example on how to reduce a private sector debt overhang after a crisis. Following the crisis of the early 1990s, the government not only revived the economy but also restored the health of households' balance sheets.<sup>1</sup> A ratio of debt to disposable income of Swedish households decreased from 130 percent in 1988–89 to 90 percent in 1996 (figure 1). What is more, households' interest expenditures halved, from 10 percent of disposable income in 1990 to 5 percent in 1997. Finally, Swedish authorities managed to keep the costs of the bailout in check. By 1997 the total bill amounted to only 2 percent of GDP, down from 6 percent in 1993.<sup>2</sup>

### The boom-bust

During the mid-1980s, Sweden experienced a credit boom and subsequent bust in the real estate sector. Consumption, investment, and asset prices were surging. The real house price index grew from 97.8 in March 1985 to 136.2 in March 1990.<sup>3</sup> Loans to households and corporations rose rapidly, as did the inflation rate, which surpassed 6 percent in 1988–90, hurting the country's competitiveness. In just two years household debt as a percentage of disposable income grew from 116.9 percent in 1987 to 131.5 percent in 1989 (in comparison to 86.1 percent in the United States in 1989).



**Figure 1: Household debt and interest expenditures as a percentage of disposable income in Sweden and the US, 1981-97<sup>4</sup>**



Source: Statistics Sweden, Riksbank, Bureau of Economic Analysis, and the US Federal Reserve.

Generous taxation, liberalization of credit markets, and financial innovation together with weak supervision contributed to deteriorating asset quality and lower profitability in the banking sector.<sup>5</sup> Commercial banks in Sweden started to record smaller profits, and they turned negative in 1991; profits before taxes fell from 1.85 percent of total assets in 1986 to -0.5 percent in 1991 (Drees and Pazarbaşıoğlu 1995). Swedish GDP contracted in three consecutive years from 1991 to 1993.<sup>6</sup>

How did the Swedish government manage to rescue the financial sector? The next section provides a few insights.

### How to reduce private debt

First, the government focused on early recognition of losses. True valuations and transparency were preconditions for receiving government support. Banks were forced to write down losses according to their true valuations, markets received accurate information. The authorities guaranteed banks liabilities or took an ownership stake in the banks. Ergungor (2007) indicates that after the public acquisition of Nordbanken in 1992, the Swedish authorities owned nearly a quarter of all bank assets. Banks assets were divided into two categories: good and bad. Assets qualified as good were left in the respective banks, which continued business as usual, while troubled assets were transferred to special asset management funds (AMF). Because these funds were deliberately overcapitalized, they had the capacity to absorb losses. AMFs also enjoyed independence from the state-level decision making that, together with the funds' expertise, allowed for effective and successful management of the troubled assets. Moreover, a clear distinction between troubled and healthy assets paved the way for financial institutions to regain markets' trust.

Second, the approach was holistic but diversified. According to a bill from September 1992, the government's assistance (e.g., loan guarantees, capital injections) was available not only for Swedish banks but also foreign-owned subsidiaries located in the country and for other specific credit institutions. And the support's structure and amounts were tailored to the necessities of

particular banks or institutions. A special body—the Bank Support Authority (BSA)—was set up in 1993 to assess the magnitude of the troubled loans, as well as each bank’s earning potential in the long run.

Third, the authorities kept a long-term perspective in mind. Asset management funds that dealt with bad assets were excluded from regulations that forced banks to sell their troubled collateral within three years. Thanks to this exemption, the government avoided hastened sells that could have put additional downward pressure on fragile markets.<sup>7</sup> Although the last liquidations by AMFs took place as early as 1997, initially the government assumed a longer time frame.<sup>8</sup>

Finally, a devaluation of local currency and a decrease in interest rates followed by an export-led recovery and robust growth in the advanced world helped the country grow out of debt. Between 1994 and 2000 average GDP growth in Sweden surpassed 3.5 percent annually, practically equal to the average for Western Europe.

### **Crisis, resolution, and the cost**

Although the authorities managed to reduce the costs of crisis to 2 percent of GDP in 1997, initially bank bailouts and financial sector assistance put a strain on public finances, as most of the restructuring was channeled through the public budget. The government turned from net lender to net borrower, with net government primary borrowing of 11.68 percent of GDP in 1993. Soaring public deficits reached 12 percent of GDP in 1994, while public debt jumped from 42.7 percent of GDP in 1990 to 72.0 percent just three years later. Finally, Spilimbergo et al. (2008) indicate that only part of this decline can be attributed to cyclical factors.

All in all, reducing household debt and restoring the soundness of banks’ balance sheets should be counted as genuine achievements. Naturally, every crisis puts different challenges before policy makers. Yet, Sweden’s experience in tackling private debt overhang can provide some insights for others. First, it shows the importance of accurate information and true valuations in times of crisis. Second, it underscores benefits of an efficient management of troubled assets. Finally, Swedish experience reflects the importance of balance between support for banking sector and soundness of public finances.



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## Notes

- 1 The timeframe of this country benchmark covers the years 1985 until 1997. It is assumed that debt levels accumulated by households and corporations during 1985-1990 were unsustainable, thus suggesting a private debt overhang. In the early 1990s credit accounted for almost 70 percent of Swedish GDP, in comparison 14.5 percent in the United States and 20 percent in the United Kingdom, according to estimates of Spilimbergo et al. (2008).
- 2 Reduction of the cost was possible mainly due to two factors. First, the government took ownership stakes at the banks and was able to sell their stocks with a profit. Second, some of the troubled assets of the banks were recovered successfully.
- 3 Index 1995 q1 = 100. Source: Statistics Sweden.
- 4 For the US the category of households includes nonprofit institutions.
- 5 Prior to the 1980s Swedish regulation limited competition and placed restrictions on the availability of credit, while keeping the interest rates artificially low. Hence the demand for credit exceeded the supply, giving rise to the expansion of nonbank financial institutions. Even banks were setting up financial companies to bypass interest rate regulation. In the 1980s Sweden, like its Nordic neighbors, begun gradually to deregulate the banking sector. This process led to expansion of credit in the economy as well as greater risk exposures in the banking sector. Households' savings rates dropped from 5 percent in 1980 to -3.4 percent in 1987. At the same time, banks started to finance their lending less from deposits and more from market-based sources.
- 6 Between 1991 and 1993 Finnish GDP contracted, while Norway recorded GDP growth.
- 7 During the crisis banks were also granted a right to sell their collateral beyond the three-year limit.
- 8 Crisis legislation and blanket guarantees were abolished in 1996.