Stefan Ingves: The crisis in the Baltic – the Riksbank's measures, assessments and lessons learned

Speech by Mr Stefan Ingves, Governor of the Sveriges Riskbank, to the Riksdag Committee on Finance, Stockholm, 2 February 2010.

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It is not possible to provide a comprehensive reply to all of the questions discussed in connection with the crisis in the Baltic in the space of 15 minutes. I shall therefore give a brief summary of the assessments made by the Riksbank during the course of the crisis and something about the measures we have taken. In conclusion, I shall say a few words about the lessons that can be learned.

Before I discuss the role of the Riksbank, I would like to point out that the responsibility for developments in the Baltic countries primarily lies with their own governments with regard to economic policy, and with the banks, which have a responsibility for understanding developments in the economy and taking sustainable, long-term action.

People often seem to forget in the general debate that we are talking about three different countries here. Financial market participants also tend to see the Baltic countries as a unit, which makes it difficult to manage the crises in these countries. Of course there are many similarities between the countries, for instance, their economic expansion and decline. However, there are also important differences.

Swedish banks' commitments in the Baltic

The Swedish banks' total lending to the Baltic countries currently amounts to around SEK 400 billion. There are mainly two Swedish banks that have had a large presence in this region; SEB and Swedbank. These banks, their subsidiaries and branches dominate the markets in the Baltic and comprise 80 per cent of the Estonian market, 55 per cent of the Lithuanian market and 60 per cent of the Latvian market. Around 16 per cent of Swedbank's total lending is to the Baltic countries. The corresponding figure for SEB is 13 per cent and the figure for Nordea is 3 per cent. Swedbank's loan losses for the three first quarters of 2009 total SEK 19 billion, and 60 per cent of this stems from the Baltic countries. SEB's loan losses total SEK 9 billion, with 75 per cent stemming from the Baltic region. According to the Riksbank's own estimates, the three banks' total loan losses in the Baltic region will be SEK 27 billion for the whole year 2009, and roughly the same in 2010, with around 80 per cent, or SEK 50 billion, falling to the lot of Swedbank and SEB. This figure of SEK 50 billion should be regarded in the light of the two bank groups' total primary capital, which is SEK 185 billion, or the capital held in their Baltic subsidiaries which amounts to SEK 27 billion. It will be necessary for the parent banks to continue transferring capital to their subsidiaries to maintain their creditworthiness. Assuming that developments in Swedbank's and SEB's other markets continue to be relatively good, however, the bank groups should be able to cover most of the losses from the Baltic region with the earnings from the remainder of their operations. Swedbank and SEB have subsidiaries in the Baltic countries, while Nordea has a branch. According to EU regulations, the authorities in the country where subsidiaries are located have responsibility for their supervision, while the home country authorities have the responsibility for branches and for the bank group as a whole.

Around 80 per cent, equivalent to SEK 320 billion, of the Swedish banks' lending to the Baltic countries is in euro. These euro are lent almost exclusively in the international loan markets by the parent bank in Sweden.

The Baltic economies developed rapidly after these countries gained their independence, although there have been some setbacks. This development was supported by extensive inflows of capital from abroad, particularly after EU membership in 2004. Much of the money came from neighbouring countries such as Finland and Sweden. The average standard of living for the populations in the Baltic countries increased rapidly from 41 per cent of the EU average in the year 2000 to 62 per cent in the year 2008.

Domestic and to an even greater degree foreign banks (which had better access to liquidity from their parent banks) increased their lending at a rapid rate and demand was further boosted by rather lenient fiscal policy in Latvia and Lithuania, although not in Estonia.

However, the rapid growth led to the economies overheating. As early as 2007, for instance, the rate of wage increase was 20–30 per cent a year, bank lending to the corporate sector increased by 30–50 per cent and lending to the private sector by 50–70 per cent. The deficit in the current account was 25 per cent of GDP, although that in Lithuania was slightly lower. Foreign analysts, such as the IMF, came to the conclusion that this development was not sustainable in the long run.

The course of the crisis

As a result of the large imbalances in the Baltic economies, developments would sooner or later have led to an economic crisis regardless of the external circumstances. Now the global financial crisis acted as the trigger. Investors no longer wished to take on as much risk and as the Baltic region was considered risky, with a risk of their currencies devaluating, capital was withdrawn from the region. Governments and banks, both local and foreign-owned, experienced difficulties in finding funding. The outflow led to an acute currency crisis in Latvia.

The downswing in the economies was very rapid and severe, as a number of factors combined:

- The countries' competitiveness had been undermined by the large wage increases, at the same time as the strong demand in the domestic markets had led to a waning interest in production for export.
- "Bubbles" of overproduction and high prices, primarily in the property sector, led to a more or less complete stop in construction.
- The global crisis meant that demand for the countries' export goods declined.
- The global crisis led to foreign investors being neither willing nor able to inject capital to the Baltic countries. At the same time, foreign depositors made large withdrawals from the banks.

The crisis led to GDP in the Baltic countries falling by up to 20 per cent during 2009 alone, and budget deficits soared, as did the outflow of currency, which put pressure on the foreign currency reserves. Real wages fell, unemployment rose, property prices collapsed and the number of borrowers experiencing problems repaying their loans increased rapidly. However, the outcomes in the different countries differed somewhat from one another.

How has the Riksbank assessed developments in the Baltic countries and what action has it taken?

As many of the major Swedish banks have such large commitments in these countries, the Riksbank has long been closely following developments in the region. This forms a natural part of our work in the financial stability field, which also encompasses other countries where the Swedish banks have a significant presence. We analyse statistics and other information from these countries and we discuss developments with management and employees at their central banks, governments and financial supervisory authorities. We also follow the reports on these countries from other sources such as the IMF, the EU/ECB and market data. Representatives of the Riksbank have accompanied the IMF on several of their visits to the Baltic countries and have taken part in the discussions with governments and public authorities there. The purpose of this participation, which has been at the invitation of the countries concerned and of the IMF on each individual occasion, has been to acquire up-to-date knowledge of the situation in the country and of the negotiations, so that the Riksbank could, if necessary, provide financial support at very short notice.

The Riksbank's Financial Stability Report, which is published twice a year, sounded a warning as early as 2005 regarding economic developments in the Baltic region and the tone has gradually sharpened in the reports published since then. The Financial Stability Report also publishes the results of stress tests, in which the banks' resilience is tested in the light of improbable but nevertheless possible scenarios. Examples of some of the scenarios tested include the effects on the banks of various crisis situations in the Baltic region. Back in 2006 we made the first stress test based on a possible worse development in the Baltic region and noted that if this were to occur, the banks' resilience would deteriorate and their scope to manage other negative shocks would be reduced.

The Riksbank's Deputy Governor Lars Nyberg informed the board of Finansinspektionen (the Swedish financial supervisory authority) of his fears regarding developments in the Baltic. Mr. Nyberg raised the issue in Finansinspektionen, in the summer of 2008, that the capital adequacy requirement for Swedish-owned banks with operations in the Baltic region should be raised to compensate for the higher risk. However, the board concluded that bank groups' capital already exceeded the legal minimums on a consolidated, group-wide, basis and thus the parent bank could transfer part of its excess capital to a subsidiary in the Baltic countries, if necessary. Hence, no further measures were required.

The Riksbank has regularly informed the Swedish banks of our assessment of risk in the Baltic countries. We have also required that the banks send us supplementary information so we can analyse the potential risks in greater detail. In addition, together with Finansinspektionen we have visited the banks' subsidiaries and branches in the Baltic countries to study in detail, for instance, their loan management.

The Riksbank has for several years now carried out regular crisis management exercises regarding financial crises. In 2007 a crisis management exercise was held together with all of the Nordic and Baltic countries, where the scenario involved a crisis in a cross-border Nordic bank. The purpose was to get the countries to cooperate in analysing and solving problems and to clarify the distribution of roles and responsibilities.

When the crisis moved into an acute phase in Latvia in December 2008 and large amounts of capital left the country, a loan agreement was signed at very short notice with the Riksbank and Danmarks Nationalbank on the one side and the Latvian central bank on the other side. The agreement totalled EUR 500 million, around SEK 5 billion. The main purpose of the agreement was to support Latvia's foreign currency reserve up to the point when the first payments from the IMF and EU became available. One condition was that Latvia should sign an agreement with the IMF, as the Riksbank neither can nor should become involved in assessing whether or not the country is making the necessary economic adjustments. The Riksbank's assessment was that if Latvia had not received extensive financial support from abroad at this stage it could have led to uncontrolled exchange rate depreciation and very large currency outflows.

In February 2009 the Riksbank offered an arrangement to the Estonian central bank for short-term currency support. This arrangement was never used. Its purpose was to give the central bank the possibility to provide emergency liquidity support in the event of an acute crisis in local currency to the Swedish subsidiaries. It thus had a different purpose than the agreement with Latvia. Given Estonia's own currency board arrangement, it would not otherwise have been possible for them to provide support other than on a very small scale and the Swedish authorities would have been forced to take full responsibility for a liquidity injection. This agreement is a good example of the allocation of responsibility between countries with interwoven financial systems.

The legal base for the Riksbank's loan arrangements with Latvia and Estonia is described in the Sveriges Riksbank Act, which enables loans to be granted for monetary policy purposes and currency policy purposes. An acute crisis in these countries would probably have such repercussions in Sweden that it would be difficult for the Riksbank to conduct efficient monetary policy, and the exchange rate would probably be weakened to an extent which would be detrimental to Sweden's economic development.

The Riksbank has strengthened its own foreign currency reserve through extensive borrowing abroad to have sufficient resources to be able to act effectively in a crisis. The size of the foreign currency reserve prior to the borrowing was not adequate to meet the demand for support measures that arose. When access to foreign markets disappeared after the Lehman collapse in the autumn of 2008, demand for foreign currency from the Riksbank increased sharply.

Why has the Riksbank acted in the way it has?

When foreign market participants assess the situation and risks for Sweden and Swedish financial institutions, they also take into account to a large degree what is happening in the other Nordic countries and in the Baltic countries. The global financial crisis has affected financial stability in Sweden, although financial institutions here have coped better than those in many other countries. At the end of 2008 and the beginning of 2009 there was considerable international uncertainty and the market was particularly sensitive to consequences for Swedish banks resulting from the crisis in the Baltic. There was thus good reason for the Riksbank to take measures to stabilise the situation among the major Swedish banks in accordance with its task "to promote a safe and efficient payment system".

As the problems of the Swedish banks concerned mainly lay in the Baltic region, there was even greater justification for aiming the measures at strengthening these countries and thereby the banks there. The costs of these measures would probably be much lower if the problem could be dealt with at source rather than waiting until it had spread to the parent banks in Sweden, for instance through a dead stop in the liquidity supply from international markets. When the Riksbank made an assessment of the resources required to manage a widespread Swedish bank crisis, we took into account the fact that the Swedish banks' balance sheets nowadays amount in total to 3.7 times Sweden's GDP (which can be compared to 1.2 times GDP during the bank crisis in the 1990s).

There is a debate regarding the fixed exchange rates in the Baltic countries. The Riksbank has no reason to question the Latvian government's wish to retain its fixed exchange rate. The main argument for our stance is that the Latvians themselves wish to maintain a fixed exchange rate to be able to ultimately apply to adopt the euro. They are prepared to make far-reaching sacrifices in the form of wage reductions, budget cutbacks and the ensuing unemployment, to attain the cost reductions that will restore competitiveness. I consider that the possibilities for the Latvian government to obtain popular support for such painful measures would be greatly undermined if other countries were to force an unwanted solution on Latvia. Nor is devaluation an easy path to take. There are considerable risks that it will not be possible to control the magnitude of the exchange rate changes and that there may be large distortion of the economy.

I also want to refute the argument that the Riksbank is supporting fixed exchange rates in these countries because the Swedish banks would suffer large losses in the event of devaluation. Devaluation or not, economic restraint is required over a long period of time to restore balance to the economies. This implies that the banks' loan losses will be around the same size in both alternative scenarios, but will probably have a slightly different distribution over time.

What has the Riksbank learned?

As I have described, the Riksbank had detected at a relatively early stage that the Swedish banks' lending in the Baltic region was not sustainable and that it would lead to significant risks. Admittedly, the severity of the risks did gradually become clearer as time went. We took a number of measures, although they were all of a ”soft” nature, such as discussions with the banks, with the authorities in the Baltic countries and with Finansinspektionen. However, it became clear that these measures did not have the intended effect. This is not a unique phenomenon; experiences from many countries show that it is very difficult for the authorities to require constraint from the banks as long as their profitability remains good and loan losses are low. A complicating factor was that the authorities in the Baltic countries did not see the impending risks, but expressly encouraged the Swedish banks to maintain a high level of lending. The Riksbank lacks sharp, legally-binding instruments for dealing with the banks in these situations. Prior to autumn 2008 there was also no Swedish framework for crisis management, and there are still significant shortcomings in the public management of individual banks in distress, which became clear in the case of Custodia. The Riksbank is currently analysing what further tools that might prove necessary.

The Riksbank is also considering how our messages regarding risks to financial stability can be made clearer. Perhaps they must be based on a clearer interpretation of our mandate in the Sveriges Riksbank Act which currently states that we shall “promote stability in the payment system”. Perhaps we need to use more formal measures to a greater extent, such as expressing our recommendations in letters to the parties concerned. Regardless of the importance of clarity, it is always a sensitive issue to determine at what point the Riksbank can issue warnings regarding weaknesses in the financial system. This is of course even more difficult when it refers to another country. The Riksbank therefore also works through non-public contacts with other authorities in Sweden and abroad, with international organisations and with the Swedish banks. It is important to achieve consensus on the problems and possible measures. Of course, it is also very important to make our views public to put pressure on those concerned and to inform a broader public. – The Riksbank's basic outlook is that we shall be as open and clear as possible.

One lesson learned from both the global crisis and that in the Baltic countries is that the regulation and supervision of the financial sector must be strengthened. This entails, for instance, more and better capital in the banks, stricter requirements regarding the banks' liquidity and risk management in general, as well as stricter supervision of large, cross-border bank groups. The Riksbank works actively in various international forums such as the EU/ECB, the BIS and the IMF to be able to detect at an early stage weaknesses that could lead to financial crises and to meet threats to stability. We support in various ways the endeavours to strengthen and harmonise international regulations and supervision work in different countries.

Concluding remarks

The economic downturn in all three Baltic countries is a deep one. There are some indications that the recession may have bottomed out or is at least close to it. The trade and current account balances have improved, which is mainly due to domestic constraint, but to some extent also to improvements in exports. The pressure on the currencies has declined. It is easier for the countries' governments to fund their budget deficits. Although those deficits are still high, they appear to be held in check, at least temporarily, through drastic fiscal stabilisation measures. The IMF's and the EU's loan programmes for Latvia are still in operation. With regard to Estonia, efforts are being focused on clarifying the conditions for a possible adoption of the euro as early as the turn of the year. All three countries have recently succeeded in acquiring loans on the international markets.

But at the same time as we note these positive signs, we must be aware of the continued crises in the economies, with high and rising unemployment, and a heavy fall in GDP, consumption and investment. On the financial side, we can see that the number of borrowers who are unable to repay their loans is increasing rapidly. Both foreign and domestic banks must make corresponding provisions for losses, which has made an impact on, for instance, Swedbank's and SEB's interim reports.

As consumption demand will be weak for many years, the way out of the crisis must be through investment and exports. This is only possible if competitiveness improves through further reductions in real wages. Moreover, demand from abroad must increase from the low levels experienced during the crisis.

Finally, I would like to stress for the sake of clarity that the Riksbank, and thus the Swedish taxpayers, has not lost any money on the transactions with the Baltic countries. Those who have suffered financial losses are the banks' shareholders, who have been forced to compensate for the losses with new capital. But there is also another loss – in addition to the economic contraction which the citizens of the Baltic countries currently suffer from – that is more important, and this concerns the Swedish economy as a whole. When banks make losses abroad they do not have the same possibilities to provide loans in Sweden, and thus our country may have poorer economic development. The Riksbank has done all it can to prevent such a negative development.