NORDICS IN GLOBAL CRISIS

Vulnerability and resilience

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Preface

The world is experiencing its worst slump since the Great Depression in the 1930s. The Nordic countries have, with the exception of Norway, been hit harder than most. Due to its sharpness and depth, the crisis is opening up or reviving a broad agenda of important policy issues. This report raises a number of the issues and discusses the scope for economic policies to contribute to the resolution of key economic problems.

The report can be seen as a sequel and as complementary to an earlier report on the Nordic Model, presented two years ago by a team including three of the authors of the present report. While the earlier report was focused on structural issues, the one at hand is about macroeconomic and financial issues.

The members of the team are eminent economists and authoritative experts on the issues covered. The report is a joint product, reflecting extensive discussions and cross-comments on individual contributions.

The efficiency and speed of the editing by Kimmo Aaltonen and Laila Riekkinen is without comparison.

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Helsinki 19 January 2010

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Hans Tson Söderström was from 1970 until 1984 Research Fellow, Senior Fellow and finally Deputy Director at the Institute for International Economic Studies at Stockholm University. Between 1985 and 2002 he served as President and CEO of SNS – the Swedish Center for Business and Policy Studies. From 1985 to 1995 he was chairman of its Economic Policy Group presenting annual reports on Swedish economic policy. Since 1992 Söderström has served part time as Adjunct Professor of macroeconomic analysis and policy in the Department of Economics at the Stockholm School of Economics (SSE). Between 2004 and 2006 he was responsible for the school's executive education branch, first as President and CEO, then as executive chairman. Professor Söderstöm's main area of research is macroeconomic policies in small open economies. He has produced a number of scientific papers and textbooks in the area and has also served widely as policy advisor.

Vesa Vihriälä is, since February 2004, State Under-Secretary in the Finnish Prime Minister's Office and Secretary General of the Economic Council. He received his Doctor of Social Sciences (Econ.) degree from the University of Helsinki, where he also worked as a researcher. In addition, he has studied at the Massachusetts Institute of Technology. Dr. Vihriälä had a long career at the Bank of Finland, where he worked on monetary policy and financial market regulation in the 1980s and had a central position in the crisis management activities of the central bank during the banking crisis in the early 1990s. He has also served as Economist at the OECD (1989–1991) and as the Managing Director of Pellervo Economic Research Institute (1997–2004). In his current position Dr. Vihriälä has focused on Finland's globalization strategy, labour market issues and ageing policy.

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1 INTRODUCTION AND SUMMARY: PUTTING THE CRISIS INTO PERSPECTIVE

During the past two years, the world has experienced its most severe slump since the Great Depression in the 1930s. As so often is the case, the financial sector has played a key role in the unfolding of the crisis, even though the root causes may lie elsewhere.

The global crisis opens up a broad agenda of policy issues

Due to its sharpness and depth (figure 1.1), the current crisis has initiated a wide debate on the supposed self-correcting properties of the market economy, on the need for more effective regulation and supervision of financial markets, and on the role of macroeconomic stabilization policies. It has led to a re-evaluation of the doctrine that monetary policy should be geared only to price stability (in a narrow sense), without the ambition to prevent or attenuate the inflation of asset price bubbles and financial fragility. It has revived the view that active or discretionary fiscal policy will occasionally be needed to complement the workings of automatic stabilizers. The crisis throws new light on the costs and benefits of the welfare state and its risk-sharing mechanisms. It calls into question the virtues of unfettered globalization and underlines the need for global institutions and cooperation to develop in parallel with economic integration and interdependence. In short, the crisis is opening up a broad agenda of essential policy issues for renewed consideration.

This is a report on the global crisis and the Nordic economies

This is a report on the global financial and economic crisis from the point of view of small open economies with particular reference to the Nordic countries.[1] The Nordics are among the champions of free trade and globalization, and they are now hard hit by the global downturn (with the exception of Norway). The stakes are high for these countries; a stable global framework is essential, as is the capacity of their economies to adjust to changing world markets.

Why were the Nordics hit so hard by this crisis, which apparently had little if anything to do with the stability of their own financial systems or with their competitiveness in global markets? What have the Nordics done and what could they do to alleviate the domestic consequences of the crisis? What are the lessons of the crisis with regard to monetary policy and the different choices of monetary regime across the Nordic region? Is there need and scope for expansionary fiscal policy in small open economies even though fiscal multipliers may be small and large budget deficits may threaten public debt sustainability? How can fiscal consolidation and a resumption of economic growth best be reconciled? Should the Nordic countries reconsider their outward-looking growth model in view of a more unstable global economy? Is the Nordic socio-economic model an asset or a liability in the light of the crisis?

Why were the Nordics hit so hard, what should policy makers conclude and do?

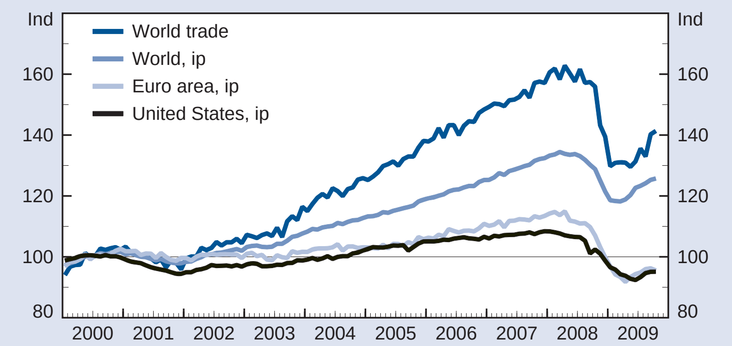

Figure 1.1
The world economy, 2000–2009
ip = Industrial production.

Sources: CPB, ETLA.

Important decisions, with effects far into the future, must be taken

These and many other questions are raised in this report. While definite answers may not come forward, we feel that it is useful to put the issues and problems into perspective and discuss what economic research can contribute to their resolution. Important policy decisions, affecting our economies and societies for years to come, are and have to be taken every day (including decisions not to act). These decisions should ideally be enlightened by sound arguments drawing, *inter alia*, on economic analysis.

This chapter sets out the main themes that are dealt with more fully in the ensuing chapters. Both the global perspective and the issues faced by small open economies are covered, with the emphasis being on the latter. The development of macroeconomic stability is looked upon in the light of broad historical facts, and the lessons of the crisis of Sweden and Finland in the early 1990s are recalled. The ways and means of safeguarding financial intermediation are examined, as are the requirements that need to be met by a more robust financial system. Special attention is paid to an extreme Nordic case: the rise and fall of Iceland. The strengths and weaknesses of fiscal and monetary policies in this crisis are covered, as are the merits and drawbacks of the different exchange rate arrangements adopted by the Nordics. Finally, we offer some reflexions on ways of limiting vulnerability and increasing resilience of small open economies in a global crisis such as the current one.

1.1 Panic strikes: Was the Great Moderation a Great Illusion?

Panic struck like lightning from a clear sky

While the term "Great Moderation" is often used to refer to the past two or three decades, it may usefully be applied to the whole post-war era, which, in a historic perspective, was a period of brisk growth and relative stability. There were admittedly a number of crises and shocks, but these were local (such as "Asian" or "Nordic" financial crises) and/or related to specific problems (such as the oil price shocks or the IT bubble). By and large, growth was satisfactory and the global economy did not suffer from major or systemic disruptions comparable to the Great Depression. The developed world seemed pretty confident that global financial crises or depressions were things of the past – until the current crisis erupted like lightning from a clear sky, causing a dramatic downturn in the global economy.[2]

Financial excesses were building up dangerous bubbles

With the benefit of hindsight, it is obvious that financial developments before the crisis were for many years characterized by global imbalances, excessive credit expansion and unhealthy increases in leverage. These were feeding both consumption and investment and the build-up of asset price bubbles. There was too little equity in the balance sheets of homeowners, corporations and financial institutions. There was inadequate understanding of the risks of complex financial instruments, of the role played by "shadow banking", and of the interconnections of markets. These all contributed to building up bubbles and spreading their consequences once they had burst.

Regulation was not up-to-date, supervision was inefficient, rating agencies made serious mistakes, and the incentive schemes faced by managers of financial institutions encouraged excessive risk taking. Given the role of securitization and innovation in the emergence of what is now seen as obvious financial excesses, it is not surprising that banks and other financial institutions have been subjected to criticism. However, while much criticism may be warranted and there is room for many improvements in the financial area, the bashing of bankers should not stand in the way of thorough analysis of the systemic problems behind the crisis.

1.2 Bashing bankers is not enough: The macroeconomics of lopsided globalization

Financial factors were certainly important proximate causes of the problem, but the underlying causes of the crisis are less obvious and will be the subject of analysis and debate for years to come. Our favoured interpretation of the crisis is that it resulted from a conjunction of global macroeconomic imbalances and the workings of financial markets.

The dynamics of globalization can result in unsustainable financial imbalances

The process of globalization has in the past couple of decades been very rapid but also lopsided. Hundreds of millions of workers, mainly from Asia, have entered production geared to international markets. This process has improved, inter alia, the lot of poor Chinese and Indians workers, while at the same time helping to keep down prices of manufactured goods and moderating global inflation. While this process of globalization and productivity growth has increased the *supply* of goods and services in world markets, it has not to the same extent increased the global *demand* for goods and services.

The saving rate in Asian countries, notably in China, is extremely high (roughly half of GDP), and the financial markets of these countries are not able to offer attractive assets to households and companies with financial surpluses. While the investment rate has been high, it has nevertheless been substantially lower than the saving rate. This has resulted in a "savings glut" looking for safe and liquid investment opportunities in countries with a shortage of domestic saving and developed financial markets, notably in the US.

Big money chasing high returns encourages excessive leverage and risk taking

The large financial flows looking for investment outlets contributed to keeping real interest rates low world wide. The abundance of liquidity and low interest rates encouraged financial institutions and holders of assets to try to raise the rate of returns on their asset portfolios by increased leverage at the cost of higher (and underestimated) risks. The large current account deficit of the US and other developed countries was not only a reflection of low household saving and lack of fiscal responsibility in these countries but also of the large Asian (and Middle-East) supply of financial saving. This is why the large US budget and current account deficits did not raise interest rates nor trigger a plunge of the dollar.

The way the financial markets have functioned in key countries has contributed to the asset market bubble, fragile financial structures and the eventual disruption. Financial innovation created highly complex instruments and avenues of intermediation ("shadow banking"), which made it easy to borrow and attractive to invest in seemingly low-risk assets. This facilitated and encouraged higher leverage than had been possible in a financial system with more adequate regulation and supervision.

What cannot go on forever, will come to an end

The tensions inherent in the unbalanced globalization process were more or less hidden as long as American consumers and the federal government were willing to spend more and borrow more. And this borrowing could go on for a long time without apparently causing problems, precisely because China (and Arab countries) was willing to buy US government bonds and other debt instruments at low interest rates. The problem emerged only when it became only too obvious that the build-up of borrowing and of asset price rises was coming to an end, as became the case in light of high and rising interest rates and prices of oil and other raw materials in 2006–2007.[3]

The errors committed by the management of financial institutions as well as the shortcomings in regulation and supervision of banks and other financial institutions are undeniable, but they are not at the root of the issue. The global crisis emanated from the conjunction of widespread financial fragility and a lopsided globalization process, proceeding rapidly amidst large financial imbalances.[4]

1.3 The Great Stabilization prevented a repetition of the Great Depression

The world economy started declining when American consumers stopped buying

Once the increase in asset prices was reversed, the financial system rapidly found itself in serious difficulty with write-downs and distress selling of assets as well as lack of liquidity and capital. And once lower leverage became a main ambition of households and firms in the US and elsewhere, global demand in the world economy started shrinking. The financial and real effects triggered mutually reinforcing chain reactions. The panic of in the autumn of 2008 caused such disruptions to financial intermediation around the globe that even companies in basically sound position were forced to cut back on spending due to lack of short-term credit. Suddenly all factors pulled the world economy in one and the same direction: downwards.

What went down comes up, but slowly

However, the past couple of years have been a period of many surprises. While the sharpness and synchronization of the decline in the world economy in late 2008 and early 2009 was a surprise, so was the stabilization achieved as early as in the middle of 2009. The recession has now been declared over in many countries, and a recovery – albeit weak and hesitant – seems to be underway (figure 1.1). If the recovery is confirmed and gathers strength, then this is clearly a crisis which did not end in a second Great Depression. Such a quick turnaround of this global financial crisis would set it apart from much of historical experience, which suggests that severe financial crises are usually followed by quite prolonged downturns.

Global policy reactions were quite different from those in the 1930s – fortunately

There seems little doubt of the explanation: policies matter. In the 1930s policies were either passive or contractionary when they should have been expansionary. This time policy reactions have been quite different: starting from the autumn of 2008, authorities have demonstrated unprecedented policy activism. First, central banks – led by the Federal Reserve – slashed interest rates and, when short-term rates approached zero, expanded their balance sheets by "quantitative easing", i.e. by unconventional purchases of securities. Second, authorities undertook a number of measures to save and prop up individual financial institutions and to safeguard the functioning of financial systems. Third, automatic stabilizers were complemented by large-scale discretionary fiscal stimulus in the US, most European countries and China. The path of recent monetary and fiscal expansion in the US and the euro area is illustrated in figure 1.2, with short-term interest rates and the public sector's financial surplus as indicators of policies pursued (such that a movement downwards or to the left indicates an expansionary stance).

It would be premature to claim that the danger is over and that stability has been restored. The recent problems in Dubai are but one reminder that many financial institutions are still over-leveraged, and that there may be more to come. Nevertheless, recent experience gives comfort and confidence. It testifies to the capacity of policy makers to take largely adequate action with speed and determination in crisis conditions.

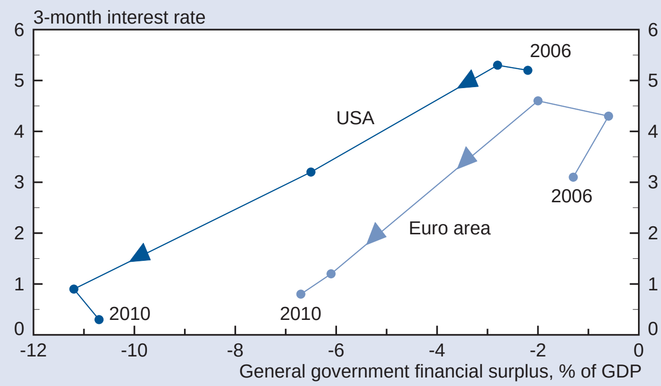

Figure 1.2
Monetary and fiscal expansion, 2006–2010

Source: OECD, Economic Outlook No. 86, November 2009.

1.4 Regulation and stabilization: Do we need more?

There is no doubt that economic crises have been much less frequent and less severe in the postwar period than during the interwar period or the 19th century. A comparison of macroeconomic policies and frameworks of financial regulation over this long period suggests that macroeconomic stability may be seen as resulting from a confluence of financial regulation and macroeconomic stabilization. The Great Depression in the 1930s is here the watershed: it initiated an era of tight financial regulation and active macroeconomic stabilization policy. This, arguably, is the main source of reduced volatility in the world economy since World War II.

Reduced volatility reflects the confluence of financial regulation and macroeconomic stabilization

Then came a backlash. Financial regulation was relaxed over the years, notably in the US, while at the same time financial innovation increased the complexity of financial instruments, institutions and markets. By consequence, regulation and supervision of the financial system became increasingly out of date and

Financial regulation was relaxed and increasingly out of date increasingly insufficient to identify and cope with the ever bigger risks involved.

Also, the nature of macroeconomic policies was changing, partly as a result of previous policy failures and partly as a consequence of developments in macroeconomic theory and empirical research. It was widely agreed that the fine-tuning ambition of earlier Keynesian policy had created more problems than it had solved. The resulting doctrine claimed that independent central banks should have price stability as their dominant or sole target, while fiscal policy should abstain from activism and be content with the functioning of the automatic stabilizers. Furthermore, there was for many years little if any interest in issues of international policy coordination.

Market fundamentalism is out, as is belief in comprehensive state interventionism

As the crisis illustrates, it is illusory to think that markets can always be safely left to correct themselves. Governments had to prop up the financial system, and Keynesian activism in fiscal policy has been a useful complement to monetary expansion by central banks. However, these are exceptional actions in an emergency and they do not signal the return of a more prominent and interventionist role for the state in running the economy in normal circumstances.

Wish list: better regulation, stabilization and international coordination

What the world needs now is more effective regulation and supervision to reduce the likelihood of financial instability and/or better access to macroeconomic stabilization tools in times of crisis. However, this is not a call for going back to the policies and regulatory structures adopted after the Great Depression. New circumstances require new approaches and solutions. The point is rather that the work presently going on with a view to creating a better framework for regulation and supervision of financial systems, acknowledging also the need for more international coordination, should be pursued with determination. More stringent regulation may come at a cost in terms of economic efficiency foregone in financial intermediation and financial innovation, but even so a shift toward more stability is clearly justified.

It is also important to examine the scope for central banks in safeguarding not only price stability but also in preventing asset price bubbles and reducing systemic financial risks. Furthermore, the crisis has given renewed impetus to the search for ways in which fiscal policy can best counteract a collapse in domestic demand. Finally, the need for international macroeconomic policy coordination – and well-functioning institutions to handle it – became evident from the global character of the present crisis.

1.5 Some economies suffered more than others

While the epicentre of this crisis is the US, many other countries were hit as hard or even harder. Many of these countries were small open economies, naturally vulnerable to global developments.

Authorities of small countries cannot be entirely absolved from responsibility, however. All shocks were not external in origin, and domestic institutions and policies are also relevant for the aftermath of shocks.

Some countries allowed a build-up of bubbles, waiting to burst

Some of the more extreme cases, such as Ireland and Iceland, had predominantly homemade crises that were only ignited by the global developments. They had for years been pursing lax or expansionary policies and did far too little to ensure adequate regulation and supervision of their financial systems. In retrospect it is clear (and, according to many observers, not only in retrospect) that these countries allowed credit expansion to proceed and a real estate bubble to build up in an unsustainable fashion. The decisive impulse for the collapse may have come from overseas, but these bubbles were waiting to burst. On the fiscal side, lax policies were not only unfortunate in allowing the bubbles to develop, but misplaced also in leaving too little room for accommodating or expansionary policy to alleviate the consequences of the crisis once it had erupted.

1.6 Lessons from Nordic experiences

The report considers experiences and lessons of the Nordic countries of, two episodes in particular. One is the financial crisis experienced by Sweden and Finland in the 1990s, the other is the Icelandic saga.

The story of Iceland is stark and conveys many messages

In the past decade the economy of Iceland first went through the roof and then through the floor; its collapse is one of the worst in recent European history. Also, the story about Iceland in the past decade is not only about serious mistakes in economic policy, though there were many such mistakes, but also about bad governance and lack of political accountability. The Iceland story is not representative of developments in the Nordic area more generally. However, the sequence of events in Iceland is of interest not only for their own sake, but also because they bring out in stark form lessons that are relevant for countries far away from the shores of Iceland.

For the other Nordics, a financial crisis is nothing new, though this one was not homemade

Finland and Sweden were badly hit by the current crisis, mainly because of their high degree of openness and their dependence on exports of investment goods, for which the decline in global demand was particularly pronounced. Nevertheless, the mental shock caused by the crisis may have been smaller than in many other countries, mainly because a financial crisis was not a new experience (there was a distinct feeling of déjà vu). This is because the two countries suffered an equally severe crisis in the early 1990s, although that crisis was largely homemade while the current crisis is not.

Sweden and Finland learned a lot about how to handle a banking crisis

The crisis in the early 1990s was a traumatic experience with many lessons, even if the two countries interpreted the lessons slightly differently. First, Sweden and Finland became aware of the difficulties and the importance of safeguarding the process of financial intermediation, and they learned a lot about the ways in which a banking crisis can or should be handled. One of the lessons learned is that the first signs of financial fragility must be taken seriously and policy planning should be based on a worst-case scenario. Both liquidity and solvency issues will need to be handled in a solid crisis management framework. A blanket government guarantee is a straightforward way of restoring confidence, but it raises a host of problems of moral hazard. Fresh capital will need to be injected into undercapitalized financial institutions, and precautionary capital injections with appropriate conditions may be useful. However, the government should not shy away from taking over institutions in which most of the capital is needed to cover expected losses. A transfer of assets into a "bad bank" is fraught with valuation difficulties, but can still be a useful way of managing impaired assets.

Many of these experiences and lessons are relevant for decisions recently taken or under consideration around the world.

Finland and Sweden drew different lessons for the monetary regime

A second key lesson was that a fixed but adjustable exchange rate, in a world of free capital mobility, is a recipe for disaster. This is why both countries opted for a floating exchange rate at the time, but it is also a main reason why Finland later adopted the euro. A third lesson was the importance of maintaining credibly sustainable public finances so as not to be forced to undertake fiscal tightening in a severe downturn but instead to leave room for expansionary fiscal action. These lessons made the two Nordic countries relatively well prepared for the global financial crisis, and their experiences of the banking crisis were helpful to other countries as well. The issues are set out below and discussed extensively in ensuing chapters.

1.7 The world needs a more robust financial system

Action on many fronts is called for to create a robust financial system

An important contributory factor in practically all major crises is excessive risk taking and high leverage of both financial institutions and non-financial entities. Action to reduce the risks of financial fragility and instability should be taken in the area of regulation and supervision, and the action should be subject to international harmonization or coordination.

Many reforms are needed. Capital requirements should be strengthened by, *inter alia*, raising their overall level, broadening their coverage and mitigating their tendency to pro-cyclicality. Existing rating arrangements need reform to eliminate incentive problems. Where executive pay is linked to performance, its measurement should have a rather long-term orientation. Ways need to be found to deal with the "too big to fail" problem to avoid weakening the incentives for prudent behaviour of big financial institutions. However, there should be no illusion of a perfect regulatory solution.

Supervision should focus on systemic issues in addition to individual institutions, which requires both sufficient powers and

International coordination with clear responsibilities in supervision of cross-border banking is essential

coherence of action of authorities within a country and across national borders. Regulatory reforms under preparation both nationally and internationally, including the EU, address many of these issues. However, there remain pressing problems concerning the adequacy and allocation of powers in cases with serious risks of solvency problems, notably so in situations where cross-border activities of financial institutions are significant. There is little ground for complacency or for assuming that reforms presently foreseen will suffice to ensure that new problems of financial stability can be avoided.

1.8 Exchange rate flexibility is no panacea

The Nordics have opted for different monetary regimes

One of the most important macroeconomic policy decisions that a country takes is the choice of monetary and exchange rate regime. The options in this regard are rather different within and outside the European Union. While the Nordics are in many ways quite similar (history, public institutions, culture) and interdependent, they have made different choices with regard to their relations to the European Union and also with regard to their monetary regime. A comparison of Finland and Sweden is particularly interesting, almost a laboratory experiment, as Sweden has chosen a floating exchange rate in conjunction with an independent central bank geared to price stability, while Finland has joined the European monetary union. Who made the better choice?

The Swedish krona fell in the crisis, improving the competitiveness of Sweden, not least relative to Finland

The krona was mostly stable in relation to the euro, and developments in Finland and Sweden were strikingly similar during the first decade of the euro, but this was a period of favourable global conditions. The last two years have been trying times. Once the crisis erupted, the krona fell significantly relative to the euro. It has subsequently risen somewhat, but its exchange rate is still relatively low. This has strengthened the price competitiveness of Sweden relative to Finland and the euro area in general. One might think that this should help Sweden to come through the crisis at less cost than Finland and other euro area countries. A lower exchange rate reduces real income and thereby domestic demand, but the improved competitiveness should improve net exports. If so, one might argue that Sweden is benefiting at the expense of its neighbours by capturing market shares from its closest competitors, notably Finland.

The floating krona has not insulated Sweden from the crisis, the exchange rate may matter less than often thought

The decline in exports and output in 2009 was indeed smaller in Sweden than in Finland, and output is forecast to recover somewhat faster, but the differences do not seem large. In particular, manufacturing output shows little response to the change in competitiveness. GDP has declined less than in Finland (though more than in the euro area), but unemployment is rising in parallel with developments in Finland. Either the effects of the improved competitiveness are relatively modest, or the lags are long. One conclusion might be that a depreciation of a floating currency has less effect on export and output volumes than a devaluation of a pegged currency used to have, because companies are reluctant to react to uncertain and maybe temporary variations in the exchange rate. If so, the depreciation of the currency should be reflected in higher profit margins, which may benefit companies in the longer run. At any rate, the floating exchange rate does not seem to insulate the economy against external shocks. The economic differences between the two exchange rate regimes seem smaller than claimed in the often heated debate about the EMU.

1.9 The EMU is increasingly subject to strains

Divergence is increasingly a problem within the euro area

Staying outside the euro area may not be a great advantage for the Swedish economy as compared to the Finnish, but this does not mean that all is well in the euro area. One particular problem, which has become much more visible in the crisis, is the persistent divergence between North and South (with Ireland being a separate case): the countries in Southern Europe have for years been losing competitiveness as well as running large and persistent deficits in public finances and the current account. The problems have piled up in the past decade, partly because the euro has reduced the political pressure for corrective policy actions by protecting these countries against negative financial repercussions of growing public debts in the form of exchange rate tensions or interest rate hikes. The big decline in interest rates on, inter alia, government bonds experienced by these countries upon joining the euro was not used to strengthen public finances but rather to increase public expenditure. The Stability and Growth Pact was meant to prevent such developments but the pact is lacking teeth and is not effectively implemented.

Financial markets have started to require risk premia for borrowing by countries with weak public finances

As a consequence of the crisis and increased risk awareness, countries with weak economic prospects and weak public finances have increasingly been confronted with rising interest rates on their bonds. Financial markets are now taking over the function which the Stability and Growth Pact has been unable to fulfil. This may be conducive to fiscal discipline, but it may also lead to painful economic developments and tensions with regard to policies, including the monetary policy run by the European Central Bank. Anyway, the present risk premia on bonds issued by Greece and other countries in Southern Europe (and Ireland) are a reminder that markets are highly uncertain about how these countries are going to be able to achieve economic growth and improved public finances without a mechanism for improving competitiveness more quickly than through wage moderation.

1.10 Fiscal policy may not be all that powerful but it is still essential

The effects of fiscal policy on demand are open to doubt, notably in highly open economies,

There is little doubt that financial crisis management has been essential to prevent financial meltdown and to safeguard the functioning of the financial system. Also, there is agreement on the important role played by central banks by slashing policy rates and in ensuring liquidity of the banking system and beyond. The role of fiscal policy is more controversial, particularly as concerns the significance to be attached to discretionary action of fiscal stimulus. Some believe that fiscal expansion has been of key importance to support growth of demand and output, while others think that the effects of expansionary fiscal policy are trivial and more likely to be harmful than useful. Both theoretical considerations and empirical estimates give rise to wildly differing assessments for a number of reasons. For small and open economies, in particular, one may doubt the power of fiscal expansion as an instrument of demand management.

but fiscal expansion can alleviate problems and allows the social contract to be respected

Nevertheless, there remain arguments in favour of fiscal accommodation and/or expansion in times of crisis. First, expansionary fiscal policy may be a useful and effective complement to expansionary monetary policy in conditions where the zero interest bound is constraining monetary policy and/or when a dysfunctional credit system reduces the effectiveness of monetary policy. Second, targeted fiscal action may be helpful in avoiding or alleviating particularly problematic consequences for, *inter alia*, long-term or youth unemployment. Third, allowing automatic fiscal stabilizers to operate is useful not only from the point of view of macroeconomic stability as such, but perhaps even more so because it allows the government to avoid resorting to hasty and potentially quite harmful decisions because of time pressure. Trying to prevent growing budget deficits in a steep downturn would imply drastic expenditure cuts or tax increases that could seriously undermine confidence among citizens. Fiscal policy gives time to plan and to undertake measures of adjustment to alleviate problems and to reignite growth in an orderly manner.

1.11 We need both growth and fiscal consolidation

Sustainable public finances must be restored,

The crisis is giving rise to large budget deficits and is thereby weakening public finances, which moreover in many countries are unsustainable as a consequence of ageing populations. Ensuring sustainable public finances is essential so as not to tilt the income distribution unduly in favour of the present generation and to the detriment of future generations. Also, sound public finances are a precondition for credibility and effectiveness of fiscal policy in future downturns. There is therefore a need for fiscal consolidation in the years to come. Yet, it is also important that fiscal consolidation does not slow down the return to brisk economic growth. Ways and means must be found to combine economic growth and fiscal consolidation.

Fiscal policy is often thought of as an instrument for managing domestic demand and thereby influencing economic activity in the short run. However, competitiveness and the supply side are in small economies of more significance for growth and jobs than the aggregate demand effects of fiscal policy. Ensuring growth-friendly tax and expenditure structures can therefore be instrumental in reconciling economic growth and fiscal consolidation, which therefore need not be conflicting objectives.

which calls for more efficiently provided government services or expenditure cuts, tax base broadening through higher employment rates,

There are several routes to restoring public finances. First, public consumption and transfer payments may be cut or the composition of expenditure twisted in a growth-friendly direction. Provision of an adequate communication infrastructure, running a well-functioning and encompassing education system, and funding of research are examples of expenditure likely to support growth. While difficult, there are also many ways of enhancing efficiency in the provision of public services. Second, the tax base may be broadened by measures to raise the employment rate, particularly by prolonging the length of working careers. A key part of the problem for public finances of aging populations is increased longevity, and the natural recipe for that problem is a higher effective retirement age. We live steadily longer, better and healthier lives, and we should on average be able to stay in the workforce somewhat longer.

and more growth-friendly tax systems, including lower taxes on productive activity

Third, there is some scope for changing the structure of taxation with a view to encouraging economic growth. In practice this means reducing the share of taxes that fall directly on productive economic activity, taxes on companies and labour, while raising the share of taxes falling on consumption, natural resources and real estate. Reducing the rate of corporate taxation is, given increasing cross-border mobility, useful in both enhancing investment and in attracting the entrance of new companies.

While there are arguments for stronger international tax coordination, these arguments are not compelling and such cooperation does not seem to be a realistic scenario. Small countries, such as the Nordics, should in these circumstances decide their tax policies on the basis of the effects on their national economies and policy objectives.

1.12 The Nordic model is both vulnerable and resilient

The Nordics are vulnerable to global economic shocks

The Nordic countries have been hit harder by the crisis than the OECD countries on average, with the exception of Norway (figure 1.3). This is no coincidence but a consequence of the economic strategy of these countries, which is oriented toward exploiting globalization as a means of raising productivity and income. But while beneficial, the globalization process is also fraught with risks and problems, as the current crisis so clearly demonstrates. Assuming that the world may be more unstable in the future than in the past, due to increased financial complexity and the strength of mutual interdependence, where does this leave the Nordics with their emphasis on openness?

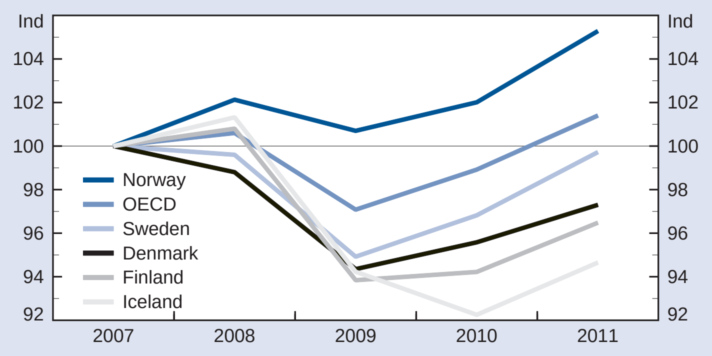

Figure 1.3
GDP in the Nordic area, 2007–2011, 2007=100

Source: OECD, Economic Outlook No. 86, November 2009.

Globalization and sophisticated financial markets are here to stay, shocks cannot be fully avoided

Economic integration will, there is reason to hope, proceed in spite of the current difficulties. As historical experience shows, protectionism easily degenerates into a downward spiral of mutually harmful actions. Similarly, there is a genuine need for the services provided by a well-developed financial system, without which a modern economy is inconceivable. Globalization and sophisticated financial markets are here to stay, and more or less serious shocks will continue to impact the world economy. The issue is not insulation against them but alleviating their consequences for the domestic economy, and improving the prospects for adjusting to changes as smoothly as possible.

Not all shocks are external, and domestic vulnerability can be reduced

The vulnerability of the domestic economy to external developments will depend on a number of domestic factors. As already noted above it is obvious that many countries for a number of years allowed a build-up of housing bubbles that were bound to burst. While far from easy, there nevertheless is always scope for policies to reduce financial fragility and reduce the risk of serious disruptions resulting from such vulnerability. The composition of balance sheets is of importance. In addition to action in the field of regulation and supervision, many other factors influence decisions of firms and households concerning their balance sheets, including the system of capital income taxation. Strong balance sheets are helpful in reducing the repercussions of falling cash flows.

Financial buffers, private and public, are a first line of defence

Another and even more important financial buffer is provided by fiscal policy. Strong government finances allow automatic stabilizers to operate in a recession, thereby softening the blow for households and firms and the economy as a whole. Strong government finances will also permit the government to undertake discretionary fiscal action to stimulate aggregate demand when there is a decline in economic activity and to address specific problems that call for action. Another aspect is that strong public finances allow the "social contract" to be respected in times of difficulty, which helps maintain confidence of the public.

Jobs lost in a recession are often gone forever – adjustment is unavoidable

Even temporary crises will have long-run consequences; many of the unemployed will never return to permanent employment and jobs lost in a recession will in many cases be gone forever. For the economy to recover and grow, to be resilient, it is crucial for relative prices and costs to adjust in a way that enhances competitiveness and the reallocation of labour and capital from less to more profitable uses. This second line of defence depends on the functioning of the labour market and wage formation, the exchange rate system, the incentive effects of tax and transfer systems, regulation of markets and competition policies.

The Nordic model, wisely implemented, is robust and resilient

Aggregate real wage flexibility is obviously essential, notably so for countries that cannot rely on the exchange rate to improve their competitiveness. Given the strong role of labour unions in the Nordic countries, the wage moderation called for is difficult to achieve without some wage coordination, formal or informal. Flexibility in decentralized decisions on working hours is a related option of facilitating adjustment.

A high level of investment in human capital and a well-educated labour force, one of the attributes of the Nordic model, facilitate adjustment to changing circumstances by making it easier to upgrade skills through additional training. The comprehensive safety net is also valuable, particularly in times of crisis. The Nordic model is robust in the sense that entitlements are not directly conditional on the fate of individual companies or particular markets or capital market developments, as risks are widely shared in society through collective risk-sharing arrangements. Provided that governments are able to take the decisions needed to safeguard competitiveness and the sustainability of public finances, the Nordic model can be both robust and resilient. The Nordic welfare state, the labour market institutions and the educational system are not the source of current problems. Quite the contrary, the Nordic model, rightly implemented, is part of the solution.

In our view there is a lot that small economies can do to reduce their vulnerability and improve their resilience. But in the end a fundamental dilemma remains due to the gulf between the global economy and local politics. The world has been shrinking for quite some time, and the mutual interdependence of countries is stronger than ever. Yet, most policies continue to be determined by governments of nation states, and the framework for global cooperation is weak. There is a need for stronger international cooperation in areas such as trade policy, financial regulation and supervision, macroeconomic policy and actions to prevent climate change.

The global economy needs more than local politics

The crisis has revived interest in international coordination in financial regulation and supervision as well as in the area of macroeconomic policies. Stronger multilateral institutions within a well articulated system of global governance are in the interest of all, as no country is anymore large enough to be insulated from the effects of world economic tensions and disruptions. For small open economies like the Nordics, a system of well-functioning multilateral institutions of global reach is of particular importance.

Endnotes

[1] While much of the analysis in this report is relevant for all the Nordic countries, we nevertheless deal rather little with Denmark and even less with Norway (which is, because of oil, a case of its own).

[2] While financial stress was visible already in the summer of 2007, the starting point of the crisis is 15 September 2008, the date when Lehman Brothers went bankrupt. As discussed in chapters 2 and 3, this event quickly triggered strong reactions on international financial markets.

[3] There was at the time discussion of the American twin deficits, referring to the current account and federal budget deficits, which were assumed to put strong downward pressure on the dollar. This analysis turned out to be inadequate or misleading, because the deficit was driven more by foreign financial inflows into the US than by American excess demand for goods and services. Furthermore, when the crisis erupted, the dollar initially strengthened because of the "safe-haven" effect.

[4] The process of development and industrialization is typically associated with capital inflows to finance domestic investment exceeding domestic saving. Industrialization is in this case associated with a current account deficit or domestic imports exceeding exports. This means that foreign countries, which supply the saving financing the current account deficit of the country undergoing industrialization, benefit from the possibilities of expanding exports during the process. In the case of China, by contrast, industrialization has been strongly based on export-led growth resulting in large current account surpluses.