This dissertation assesses the impact of global finance on policy options in the Swedish financial crisis of 1992. The aim is to improve understanding of the impact of global finance on state policymaking during a financial crisis and to determine the extent to which a state has policy options despite global financial constraints.

Although the impact of global finance has narrowed the policy options available to policymakers, this thesis argues that there are still options available and decisive policy choices to make even in the worst case of a financial crisis situation. This study finds the common suppositions in the globalization literature inadequate for understanding a financial crisis as a consequence of their focus on either structural constraints or policy choices, and suggests a constrained choice approach focusing on the interplay between global constraints and policy choices.

This study applies the constrained choice approach to three decisions during the Swedish financial crisis. They are the decisions to defend the krona, to support the banks, and to build a political coalition. The study finds that global material and ideational constraints, as well as alternative policy options for policymakers, were present in all three decisions. As the financial crisis worsened, the global constraints on policymaking increased, but not to the extent that policy options ceased to exist. In all three decisions, the policymakers waited as a long as possible before making their policy choice. Policy choice was reactive rather than proactive. Policy responses to global constraints became crucial in defending the remaining policy autonomy in the Swedish financial crisis of 1992.

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Managing Global Finance: Choices and Constraints in the Swedish Financial Crisis of 1992

Abstract (not more than 200 words)

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Att hantera globala finansflöden: valmöjligheter och begränsningar i den svenska finanskrisen 1992

Sammanfattning (högst 200 ord)

Avhandlingen analyserar globaliserade finansflödens påverkan på policyvalen i den svenska finanskrisen 1992. Syftet med avhandlingen är att förbättra förståelsen av hur globaliserade finansflöden påverkar statens policyval under en finanskris och bestämma i vilken omfattning staten fortfarande har valmöjligheter trots de begränsningar som globaliserade finansmarknader utgör. Studien fokuserar på de tre beslutssituationerna att försvara kronan, stödja bankerna och bildandet av en politisk koalition. Slutsatserna pekar på att beslutsfattarna i samtliga beslutssituationer väntade så länge som möjligt innan de fattade sina beslut. Policyvalen var reaktiva snarare än proaktiva. I ljuset av globala begränsningar på nationella policyval blev de beslut som fattades avgörande för att försvara de kvarvarande policyutrymmet i den svenska finanskrisen 1992.

Nyckelord

Sverige, finanskris, globalisering, globala finansflöden, krishantering, ekonomisk säkerhet, policy autonomi

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Preface

This dissertation was submitted to the University of Warwick in October 2004 and passed the viva without corrections in December 2004. Dr. Magnus Ryner from the Department of Political Science and International Studies (POLSIS) at the University of Birmingham was external examiner and Dr. Ben Rosamond from the Department of Politics and International Studies (PAIS) at the University of Warwick was internal examiner. This report is a reformatted version of the submitted dissertation.

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First and foremost, I am greatly indebted to my supervisors, Professor Jan Aart Scholte and Dr. Timothy Sinclair. Without their guidance, advice and trust, this dissertation would never have seen the light of day. At various stages they have challenged my preconceptions, cut me down to size, and inspired me to go the extra mile(s!) to find the pieces that were missing.

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There are a few people who, in retrospect, stand out as crucial in leading me to the decision to pursue a Ph.D. Bo Wollinger opened my eyes for social affairs; Professor Magnus Jerneck (Lund University) was as fundamental to the development of my understanding of politics as he was instrumental in the arranging of my excursion to Canada; and Professor Mark Zacher (University of British Columbia) challenged my conceptions of globalization and was the one who convinced me to go for a Ph.D. I am thankful to them all.

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JOHANNES MALMINEN
Solna, Sweden
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Abbreviations/Names

Bankstödsnämnden	Bank Support Authority
BIS	Bank for International Settlements
Ecofin	Council of Economic and Finance Ministers
EMS	European Monetary System
EMU	European Monetary Union
ERM	Exchange Rate Mechanism
FI	Swedish Financial Supervisory Authority (Finansinspektionen)
FSAP	Financial Sector Assessment Program
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
LO	Swedish Trade Union Confederation (Landsorganisationen)
OECD	Organisation for Economic Co-operation and Development
National Debt Office	Riksgäldskontoret
Riksbanken	Swedish Central Bank
Riksdagen	Swedish Parliament
SAP	Social Democratic Party (Socialdemokratiska Arbetarpartiet)
SOU	Swedish Governmental Report (Sveriges Offentliga Utredningar)

Chapter 1: Managing the Consequences of Global Finance

1.1. Introduction

How can a state draw the benefits of increasing capital mobility and a global financial market, while avoiding their negative consequences? Since the 1990s, policymakers have been forced to think long and hard about this question. The contemporary rise of 'global finance' – defined here as transborder flows of credit, portfolio investment and savings – has had many positive outcomes, such as improved access to capital and investment, that in turn have spurred innovations and growth in many sectors, but it has also brought severe problems, for example, in the form of financial market instability and financial crises.

Already in relation to the stock market crash of 1987, George Soros pointed towards the risks emanating from globalizing financial markets. He argued that:

> The Western world has gone overboard in allowing financial markets to function unhindered by any government regulation….Financial markets are inherently unstable; stability can be maintained only if it is made an objective of public policy. Instability is cumulative….the longer markets are allowed to develop without regulation, the more unstable they become, until eventually they crash.[1]

It turned out that his warning materialized in the 1990s. As a speculator making the most out of the system, he of course made his own contribution to this development. The point here, however, is that warnings about the instability of global financial markets have been around for quite some time, but policymakers have done little to counteract and prevent financial crises.

Throughout the 1990s, crises in global finance have flared up with little or no advance notice. Although financial crisis is a 'hardy perennial',[2] in the post-Bretton Woods era the frequency of financial crisis has reached the level experienced in 1920s and 1930s. As Bordo et al. point out, "history thus confirms that there is something different and disturbing about our times."[3] At the same time, financial crisis in one country has quickly spread elsewhere to an extent that indicates that financial crisis can be contagious. This contagion effect has often

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[1] George Soros, *The Alchemy of Finance*, Reprint ed., Wiley Investment Classics (Hoboken, NJ: John Wiley & Sons, 2003 [1987]), 365.
[2] Charles P. Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises*, 4th ed. (New York, NY: John Wiley & Sons, 2000), ch. 1.
[3] Michael Bordo and others, "Is the Crisis Problem Growing More Severe?," *Economic Policy* 16, no. 32 (2001).

been unpredictable with respect to when and where it will appear next.[4] Prudent and market-oriented economic policies have not been an assurance of insulation from speculative attacks and the effects of volatile capital flows.[5] In the scramble to get in or out of financial markets ahead of the others, highly competitive financial actors pay only limited attention to what economists call 'fundamentals', and bet on their perceptions of the situation and estimations of how other actors will react. In doing so, perceptions and herd behaviour have created financial instability and policymakers have often been taken by surprise as the instability led to the outbreak of financial crisis.[6] At best, the stability of the global financial system has proven to be uncertain.[7]

During the last decade many governments have experienced the risks involved in deregulating financial markets and the lack of measures to prevent, manage and counteract the negative effects of volatile capital flows head-on.[8] Once financial actors had zoomed in on a country, it turned out to be more or less impossible for governments to defend their national economies from the damaging effects of speculation, and they were regularly forced to alter economic policies to satisfy the market sentiment and recover economically. Instead of adapting and finding measures to deal with the new situation many observers and governments derived an impossibility theorem, perceiving that governments were helpless and policymakers lacked acceptable policy alternatives.[9] Whatever policymakers tried, they passively had to await the financial market verdict of their policies and then adapt accordingly. However, the severe consequences of financial crises also led to counterarguments that policymakers still had clout and alternatives and that processes of globalization were neither new nor significant, and to demands for re-regulation, Tobin-taxes, and a reformation of the financial architecture.[10]

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[4] Graciela L. Kaminsky, Carmen M. Reinhart, and Carlos A. Végh, "The Unholy Trinity of Financial Contagion," *Journal of Economic Perspectives* 17, no. 4 (2003).

[5] Barry Eichengreen, *Capital Flows and Crises* (Cambridge, MA: The MIT Press, 2003), 103.

[6] Paul R. Krugman, *The Return of Depression Economics* (London: Penguin, 2000), 10, 110.

[7] According to Jervis, "a system is stable if it is characterized by negative feedback that keeps essential variables within prescribed limits and is unstable if a change in one direction sets of a positive feedback – i.e. is self-reinforcing by calling up forces that produce further motion in the same direction." Robert Jervis, *System Effects: Complexity in Political and Social Life* (Princeton, NJ: Princeton University Press, 1997), 96-7. See also John Eatwell and Lance Taylor, *Global Finance at Risk: The Case for International Regulation* (New York, NY: The New Press, 2000).

[8] Joseph Stiglitz, *Globalization and Its Discontents* (London: Penguin Books, 2002), 73.

[9] See, for example, Eichengreen, *Capital Flows and Crises*, 99; Linda Weiss, *The Myth of the Powerless State* (Ithaca, NY: Cornell University Press, 1998), 193.

[10] See, for example, Commission on Global Governance, *Our Global Neighbourhood: The Report of the Commission on Global Governance* (Oxford: Oxford University Press, 1995), 217-21; Eatwell and Taylor, *Global Finance at Risk: The Case for International Regulation;* Barry Eichengreen, *Toward a New International Financial Architecture: A Practical Post-Asia Agenda* (Washington, DC: Institute for International Economics, 1999); Matthew Watson,

The recurring financial crises of the 1990s have had devastating effects on national economies, citizens, and possibly even the prospects for a truly open world economy.[11] Although a considerable amount of effort has gone into improving the systemic deficiencies of global financial markets, most of the plans floating around are "politically unrealistic, technically infeasible, or unlikely to yield significant improvements in the way crises are prevented, anticipated or managed."[12] At the same time, the more acute question of what strategies and tactical measures are available to states on the brink of financial crises has largely been left out of political discussion. For example, while military threats to the state draw immediate attention and trigger pre-emptive efforts, economic threats are often overlooked. As Krasner points out, in the late twentieth century, international economic relations have become separated from political and strategic calculations to a historically unprecedented degree.[13]

Reforming the global financial system is necessary, but a changed or amended system is at best a medium-term prospect. In the meantime states have to be prepared for the worst that the current system might bring. Thus, for states it is of vital importance that the present focus on shaping the future strategic context of global finance is complemented with analysis of the tactical measures to be taken in the interim. In this context, it becomes necessary to draw on the lessons of previous financial crises and attempt to understand the policy options and constraints that global finance imposes on policymakers.

The primary focus of this study is on the constraints that global financial markets impose on policymakers during a financial crisis and what options and measures, if any, are available to cope with financial crisis. This study examines the Swedish financial crisis of 1992 as a case to understand the role of the state in managing the effects of global finance during a financial crisis. In using the Swedish case, this study assesses the impact of global finance on economic policy in Sweden in order to understand the options and constraints that policymakers faced during the financial crisis. The study approaches this principal research question through three subsidiary questions.

The first subsidiary question regards the extent to which the Swedish economy has become vulnerable to global finance since the deregulation of financial markets in Sweden during the period 1985-1989. In answering this question, the study analyses the impact that deregulated global financial markets

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"Rethinking Capital Mobility, Re-Regulating Financial Markets," *New Political Economy* 4, no. 1 (1999).

[11] See, for example, Eric Helleiner, "Post-Globalization: Is the Financial Liberalization Trend Likely to Be Reversed?," in *States Against Markets: The Limits of Globalization*, ed. Robert Boyer and Daniel Drache (London: Routledge, 1996).

[12] Eichengreen, *Toward a New International Financial Architecture*, 79.

[13] Stephen D. Krasner, "Economic Interdependence and Independent Statehood," in *States in a Changing World: A Contemporary Analysis*, ed. Robert H. Jackson and Alan James (Oxford: Clarendon Press, 1993), 310-1.

have had on Sweden's transborder flows of credit, portfolio investment and savings as well as the qualitative changes that have taken place in the Swedish economy in the 1990s.

The second subsidiary question concerns the global constraints imposed on the Swedish state during the financial crisis and to what extent these structural constraints circumscribed the manoeuvrability of policymakers. In answering this question, the study builds an analytical framework around four common suppositions regarding the impact of globalization on the state. The analytical framework specifies the theoretical perspectives and provides the lens to assess the Swedish financial crisis. The thesis argues that these hypotheses are inadequate to understand state action and policy in a financial crisis and suggests a reformulated synthesis to improve this understanding.

Given the global constraints imposed on the Swedish state during the financial crisis, the third subsidiary question regards the scope of agency in a financial crisis, i.e. what options policymakers had to choose from during the financial crisis, and why they made specific policy choices. In answering this question, the study identifies three key decisions and analyses the scope for policy autonomy in these three instances during the financial crisis. In this respect, the study assesses the capacity of Swedish policymakers to limit adverse consequences or enhance positive repercussions of global finance for national economic policy during the financial crisis.

1.2. The rationale of the study

The rationale for this study is fourfold. It has one primary and three secondary purposes. The overarching aim of this study is to improve our understanding of the impact of global finance on state policymaking during a financial crisis and to what extent a state has policy options despite global financial constraints. This is accomplished by a systematic and specific assessment of the general claims in this regard on an empirical case. In doing so, this study examines the case of policymaking in the Swedish financial crisis of 1992.

A secondary purpose of this study is to put conventional theories of the impact of globalization on the state to an empirical test. The relationship between processes of globalization and the state has been a bone of contention in academic debates over the last decades. The verdict has ranged from assertions that globalization imposes severe constraints on state policymaking to affirmations that globalization makes no impact and leaves full freedom for the state. In many cases, studies of globalization have made major claims on scant evidence and critical counterclaims have propelled the debate into the stratosphere rather than grounding it. For example, Kindleberger made such a claim as early as 1969, when he asserted that "the nation-state is just about through as an economic unit."[14] Thesis has triggered anti-thesis, but led to very little synthesis. Although the discussion has oftentimes been fierce, there have only been limited detailed case studies of what options and constraints state actually faces as processes of globalization transforms the environment wherein policies are supposed to be implemented.[15] Thus, it has been very difficult to assess and evaluate the different general claims. This study aims to relate the theories to an empirical case to evaluate their usefulness.

Another secondary purpose of this study is to complement the empirical study of the Swedish financial crisis with a perspective that frames the crisis within the processes of globalization. The Swedish financial crisis has been analysed from historical, economic, political, media, psychological, and crisis-management perspectives. These previous studies only touch upon the globalization of financial flows and the environment the policymakers operated in.[16] These studies, primarily focused on the domestic or individual situation, need to be complemented with the focus on external relations and the interplay between the government and processes of globalization.

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[14] Charles P. Kindleberger, *American Business Abroad: Six Lectures on Direct Investment* (New Haven, CT: Yale University Press, 1969), 207.

[15] Excellent exceptions in the area of financial globalization are, for example, Stephan Haggard, *The Political Economy of the Asian Financial Crisis* (Washington, DC: Institute for International Economics, 2000); Layna Mosley, *Global Capital and National Governments* (Cambridge: Cambridge University Press, 2003).

[16] See, for example, Alexander Boksjö and Mikael Lönnborg-Andersson, *Svenska finanskriser: Orsaker, förlopp, åtgärder och konsekvenser [Swedish Financial Crises: Causes, Courses, Measures and Implications]* (Uppsala: Department of Economic History, 1994), Uppsala Papers in Financial History, 2; Lars Jonung and Joakim Stymne, "The Great Regime Shift: Asset Markets and Economic Activity in Sweden, 1985-93," in *Asset Price and the Real Economy*, ed. Forrest Capie and Geoffrey E. Wood, Studies in Banking and International Finance (London: Macmillan, 1997); Bengt Larsson, "Bankkrisen, medierna och politiken: Offentliga tolkningar och reaktioner på 90-talets kris [The Swedish Banking Crisis, the Media and Policy: Public Interpretations and Reactions to the Banking Crisis in the 1990s]" (PhD Dissertation, Göteborg Studies in Sociology No 3, Göteborg University, 2001); Mats Larsson and Hans Sjögren, *Vägen till och från bankkrisen: Svenska banksystemets förändring 1969-94 [The Road to and from the Banking Crisis: The Change of the Swedish Banking System 1969-94]* (Stockholm: Carlssons, 1995); Karin Lindgren, "Vad styr ledaren? Om beslutsfattare och policyförändring i säkerhetspolitiska kriser [What Guides the Leader? How Does the Leader Guide? On Decision-Makers and Policy Change in Security Policy Crises]" (PhD Dissertation, Uppsala University, 2003); Eric Stern and Bengt Sundelius, "Sweden's Twin Monetary Crises of 1992: Rigidity and Learning in Crisis Decision Making," *Journal of Contingencies and Crisis Management* 5, no. 1 (1997); Jan Teorell, "Demokrati eller fåtalsvälde? Om beslutsfattande i partiorganisationer [Democracy or Oligarchy? On Intraparty Decision-Making]" (Ph.D. Diss., Uppsala University, 1998). The best exceptions would be Jonas Hinnfors and Jon Pierre, "The Politics of Currency Crises in Sweden: Policy Choice in a Globalised Economy," *West European Politics* 21, no. 3 (1998); Lars Jonung, "Den finansiella revolutionen, 90-talskrisen och inflationsmålet [The Financial Revolution, the 1990s Crisis, and the Inflation Target]," in *På jakt efter ett nytt ankare: Från fast kronkurs till inflationsmål [In Pursuit of a New Anchor: From a Fixed Krona to an Inflation Target]*, ed. Lars Jonung (Stockholm: SNS Förlag, 2003).

Finally, this study aims to make a contribution with policy-relevance. It seeks to narrow, if not the bridge, the gap between theory and policy. While the concept of globalization has been embraced in popular, bureaucratic, and academic vernaculars, its meaning and how to relate to its consequences have to be better understood in order that policymakers may operate more effectively in a globalizing system, where distance, territory, and time take on new meanings, change relationships and complicate policymaking. As the strategic map changes, so must the tactics. Policymakers have found that tried and tested tools can have different and unexpected effects in the transforming environment; thus they must find new approaches. As Jervis points out:

> The policymaker who is psychologically and politically unprepared for surprises is almost certain to fail; good generals not only construct fine war plans but also understand that events will not conform to them; doctors must change medications as bodies and microbes react to treatments.[17]

Without the strategic oversight and understanding of the environment that states operate in, policymakers risk wasting time, money, and energy pursuing unattainable objectives. Consequently, there is a need to bridge the cultural gap between academic studies of globalization and the policymaking sphere and to recognize that academic and policymaking enterprises can feed off each other. The policymaker can be assisted with the diagnosis of the problem situation and identification of an effective policy response, while the academic gets a practical test of the value and reach of a theory. Bridging the gap between academics and policymakers has long been an issue in foreign policy and interstate relations;[18] it needs to be an issue also when policymakers face a changing environment and powerful actors other than states. This study will not wholly bridge the gap between the academic study of globalization and policy, but it aims to bring the two a small step closer together.

1.3. The orientation of the study

Meta-theoretical points

This study is located in the field of International Political Economy (IPE). The problems addressed are all part of the dynamics and tensions that traditionally have propelled the study of IPE, such as the interplay between politics and economics, between states and markets, between international/global and domestic forces, and between structure and agency. States need markets to generate

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[17] Jervis, *System Effects*, 293.

[18] See Alexander L. George, *Bridging the Gap: Theory and Practice in Foreign Policy* (Washington, D.C.: United States Institute of Peace Press, 1993).

wealth, and markets need states to provide a framework of laws and institutions to operate.[19] This interplay is the setting for major conflicts between different kinds of actors and gives the international political economy a dynamic nature. An example of this tension in this study would be that the Swedish economy needed global finance for growth and innovation, but at the same time global finance made the Swedish state vulnerable because of the volatility and speed of transactions and the 'contagion effect' intrinsic to contemporary financial crises.

The relationship between domestic and international/global forces adds another dimension to international political economy. This study perceives the democratic state as based on the brokerage of competing interests and voices within the state, whereas governmental delivery has to be negotiated in the international arena.[20] For example, the Swedish welfare system was based on the consensus among national business and trade unions and brokered by the government, but with the impact of global finance, multinational corporations and the post-industrial society the basis for this consensus has gone. New conflicts emerge and a new model incorporating domestic and international concerns is under formation.

This study focuses on the state as the primary economic policymaker and regards the state as a gatekeeper between global finance and its citizens. The gatekeeper role of the state is most visible in developed states with an elaborate welfare system as part of the social contract, such as the Swedish state. Therefore, it is not possible to regard all states as identical. Rather, their specific characteristics are expressed around core forms (for example, level of democracy and development) and functions (for example, provision of welfare and defence). The focus on the state in this thesis does not mean that the state is the only important actor or even a unitary actor. There are a number of other actors with a vested interest in economic policymaking, such as businesses, civil society organisations, and individuals. These actors influence and participate to some extent in economic policymaking at the state level. In the end, though, the state will be held accountable to society as long as the gatekeeper role mentioned above is part of the social contract. That is the reason for the focus on the state here.

The state-market dynamic at work in IPE is conceived through the interplay of structure and agency. Structures are defined as embedded organising

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[19] See, for example, Eric Helleiner, *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s* (Ithaca, NY: Cornell University Press, 1994); Jan Aart Scholte, "Global Capitalism and the State," *International Affairs* 73, no. 3 (1997); Timothy J. Sinclair, "International Capital Mobility: An Endogenous Approach," in *Structure and Agency in International Capital Mobility*, ed. Timothy J. Sinclair and Kenneth P. Thomas (Basingstoke: Palgrave, 2001), 101; Susan Strange, *States and Markets*, 2d ed. (London: Pinter, 1994), 39-42.

[20] For the major perspectives on the state, see Martin Carnoy, *The State and Political Theory* (Princeton, NJ: Princeton University Press, 1984).

principles of social relations. The production structure based on capitalism and the security structure based on anarchy and interstate rivalry would be examples of important structures in this thesis. These structures set the boundaries within which actors make choices, but, at the same time, the structures were created by and their evolution depends on the aggregation of choices made by the actors in the system. The primary actors/agents that have a stake in global finance and economic policy in Sweden are states, businesses, civil society organisations and individuals. The relationship between structure and agency is codetermined and in a continuous interplay.[21] However, in times of change as in the case of financial crisis, structure or agency can temporarily gain the upper hand, and this dynamic takes a new direction.[22] Consequently, this thesis is informed by the notion of interplay between structure and agency, rather than being determined by structures or actors alone.

Another assumption of this thesis is the intersubjective nature of global finance.[23] This position contrasts with that of most economists and financial actors, who usually take structures for granted, purport to follow rational decision-making procedures, and downplay uncertainty, complexity, and risk. However, uncertainty, complexity and risk are at the heart of the financial market, making reliable information scarce and seriously hampering rational decision-making.[24]

In these circumstances, actors substantially rely on their own perceptions and their perceptions of others' perception. Anticipation of what is to come, trust and confidence in information, and contacts to be ahead of the game become the long-term keys to successful affairs, rather than minute analysis of the fundamentals.[25] For example, if some financial actors lose confidence in a national economy, it could trigger a self-fulfilling speculative attack. An attack could start with traders somewhere in the world coming to a negative view on a country's economy and then starting to sell their assets in that economy. By doing this, they lead other traders to form a view and, if enough of them decide to pull out, the attack is in full swing.

Another example of the intersubjective nature of global finance would be how a new idea, such as the information economy, can emerge and quickly be regarded as structurally transforming the economy and then be discarded again. Krugman even makes the argument that market psychology is crucial,

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[21] See, for example, Alexander Wendt, "The Agent-Structure Problem in International Relations Theory," *International Organization* 41, no. 3 (1987).
[22] See, for example, Jan Aart Scholte, *Globalization: A Critical Introduction* (Basingstoke: Palgrave, 2000), 92.
[23] See, for example, Sinclair, "International Capital Mobility,"; Wesley W. Widmaier, "Constructing Monetary Crises: New Keynesian Understandings and Monetary Cooperation in the 1990s," *Review of International Studies* 29, no. 1 (2003).
[24] See, for example, Stephen Green, "Negotiating with the Future: The Culture of Modern Risk in Global Financial Markets," *Environment and Planning D: Society and Space* 18 (2000).
[25] Soros, *The Alchemy of Finance*, 35-8.

because believing makes it so and in this way the prejudices and perceptions of financial actors take on the character of economic fundamentals.[26] This is not to say that the material facts of a national economy do not matter, but rather that they are intertwined with rumours, beliefs, and perceptions that rapidly drive financial markets in one direction or another. As a consequence of the speed and spread of information and financial actors that are disconnected from the market events and the consequences of their actions, it is likely that the market signals received and transmitted will be misinterpreted, produce an exaggerated response and, hence, create market volatility. Financial market actors have to take both the facts and the intersubjective dimension into consideration to prosper in global finance.

Swedish financial crisis

Among all the financial crises of the 1990s, the arguments for settling on the Swedish case were threefold. They were the need to broaden the present focus on developing countries in studies of financial crises; the spectacular features of the Swedish crisis; and the personal comparative advantage of accessing source material.

The many financial crises that followed the ERM crisis and the Swedish crisis have tended to frame the issue of crises in global finance as a problem for developing countries and as being a consequence of their underdeveloped financial markets, poor institutions, and bad policymakers. This outlook brings a false sense of security to the developed world. Most financial crises follow quite similar paths, but their specifics are different. All we can really know about the future is that the next crisis will come and that it will have similarities but not be identical with the previous one. The Swedish financial crisis is a case in point. There had not been a financial crisis in Sweden since the 1930s and there was no sense of threat or urgency until the crisis had become acute. As Eichengreen points out:

> The 1992 crisis was different from the typical industrial-country crisis that preceded it. It was more virulent. It was more contagious. It was more disruptive to output. Both capital flows and financial fragility played more prominent roles. In this sense it was a harbinger of the Tequila and Asian flu.[27]

It is necessary to remind policymakers of the risks involved, because financial crisis can be such a decisive event. It may also be useful for policymakers to apply the experiences from more similar cases of financial crisis in order to dimin-

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[26] Krugman, *The Return of Depression Economics*.
[27] Barry Eichengreen, "The EMS Crisis in Retrospect," in *Stabilization and Monetary Policy: The International Experience, Banco de México's 75th Anniversery Seminar* (Mexico City: Banco de México, 2000), 299.

ish or prevent the domestic effects of future financial crises. The specifics of the financial crises in the developing countries would be harder to apply in a developed country. Therefore, the Swedish case can serve as more valuable example and lesson for developed countries.

Another reason for choosing the Swedish financial crisis is its spectacular characteristics. The government, with the blessing of the opposition, made a strong attempt at defying the market sentiments and failed. There are few cases in the present era of global finance where governments of developed countries take on the financial market head-on. The crisis has also been regarded as the endpoint of the Swedish model and has served as an example that the state has to conform to the market sentiment. Weiss, for example points out, "the alleged unravelling of the Swedish model is now commonly accepted as an important sign that the nation-state, as a site of institutional diversity and as an agent of economic change, has no further role to play in the era of heightened economic interdependence."[28] However, if policymakers in the Swedish financial crisis could influence and manage the situation, it also shows that governments have a role to play in improving or worsening the lot for its citizens. This role vests a certain responsibility in those administering the state. They cannot take cover behind claims of ignorance or that there were no alternatives. Politics in a financial crisis can strive to be proactive rather than reactive under conditions of globalization.

Finally, there is the personal comparative advantage of being Swedish and having an affiliation with the National Defence Research Agency (FOI). This has provided an excellent vantage point from which to study the Swedish financial crisis and it has facilitated access to sources that may not have been as easily available to non-Swedish speakers.

1.4. Method and sources

Method

As mentioned above, the overarching aim of this study is to improve the understanding of the impact of global finance on state policymaking during a financial crisis and to determine to what extent a state has policy options despite global financial constraints. In achieving this objective, this study will employ a number of methodological approaches. The observations focus on the case study of the Swedish financial crisis of 1992. The major advantage of the case study approach is that it allows the case to "be intensively examined even when the research resources at the investigator's disposal are relatively limited."[29]

[28] Weiss, *The Myth of the Powerless State*, 84.
[29] Arend Lijphart, "Comparative Politics and the Comparative Method," *American Political Science Review* 65, no. 3 (1971): 691.

Eckstein has made a typology of five uses of case studies, and three aspects of this typology can be found in this study.[30]

First, the case of the Swedish financial crisis of 1992 is employed, in Eckstein's terms, as a 'heuristic case study'. It is "deliberately used to stimulate the imagination toward discerning important general problems and possible theoretical solutions."[31] In that sense the case study is an opportunity to learn more about the complexities of the problem studied. Furthermore, the Swedish financial crisis is used to refine and synthesise the identified theoretical suppositions on the impact of globalization on state policymaking.

Second, this study also makes use of the Swedish financial crisis as a 'plausibility probe.' In choosing to apply the common suppositions and the suggested constrained choice approach on a financial crisis, where the impact of global finance on state policymaking is at its strongest, this study probes the plausibility of the different suppositions on an observation where they are most likely to be correct.[32] The probe finds the suggested constrained choice approach plausible and the common suppositions inadequate for understanding the empirical case of the Swedish financial crisis. Therefore, the synthesised constrained choice approach is deemed worthwhile of further study.

Third, after this plausibility probe, this study employs the case of the Swedish financial crisis as a 'crucial case study.' The crucial case study functions as a 'test of theory.'[33] In this study, the global constraints, and policy options and responses in the Swedish financial crisis are identified and analysed to assess the validity of the constrained choice approach. The case of the Swedish financial crisis must closely fit the constrained choice approach if we are to have any confidence in its usefulness.

The single-case study method has been criticized for among other things producing indeterminate results that potentially overlook important explanations hidden in the single-case study, while being greatly vulnerable to measurement error and providing insufficient ground for making or disproving generalizations.[34] However, the objective in this study is to improve understanding of the specific case rather than establishing general laws. Furthermore, this study rests on quite a large number of observations. For example, in assessing the constrained choice approach this study selects and observes three key decisions during the financial crisis. As King, Keohane and Verba point out, "What

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[30] Harry Eckstein, "The Case Study and Theory in Political Science," in *Handbook of Political Science. Vol. 7. Strategies of Inquiry*, ed. Fred I. Greenstein and Nelson W. Polsby (Reading, MA: Addison-Wesley, 1975).

[31] Ibid., 104.

[32] On case studies as plausibility probes, see Ibid., 108-113; Gary King, Robert O. Keohane, and Sidney Verba, *Designing Social Inquiry: Scientific Inference in Qualitative Research* (Princeton, NJ: Princeton University Press, 1994), 209-10.

[33] Eckstein, "The Case Study and Theory in Political Science," 113-23.

[34] King, Keohane, and Verba, *Designing Social Inquiry: Scientific Inference in Qualitative Research*, 208-13.

may appear to be a single-case study…may indeed contain many potential observations, at different levels of analysis, that are relevant to the theory being evaluated."[35]

In selecting three key decisions in the Swedish financial crisis, the number of observations increase and the assessment becomes more rigorous. This would amount to what George calls the "method of structured, focused comparison."[36] It is focused because it deals selectively with certain aspects of the Swedish financial crisis and structured because it allows theory to guide the data collection. The number of observations is further improved by employing the method of process tracing in the empirical chapters. This method implies following a sequence of events rather than focusing on the final outcome and this increases the number of theoretically relevant observations.[37] This study traces the development of the crisis and the policy responses made. Another approach to increase the number of observations is to pose the counterfactual question of what would have happened in the imagined case where everything is equal except the presumed causal factor.[38] In this study, the counterfactual analysis is employed primarily in discerning the policy options and choices in response to the global constraints on policymakers.

Sources

This study draws on many types of sources. The most important category is the memoirs of participants in the crisis management effort and elite interviews with them. The semi-structured elite interviews were carried through relatively late in the research process to be able to pose focused questions and have a better initial understanding of the interviewee's position, role and perspective on the financial crisis.

Otherwise, the study makes use of primary sources in the form of parliamentary and official documents, and secondary sources, including scholarly and popular works on the financial crisis, as well as the print media coverage.

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[35] Ibid., 208.

[36] Alexander L. George, "Case Studies and Theory Development: The Method of Structured, Focused Comparison," in *Diplomacy: New Approaches in History, Theory, and Policy*, ed. Paul Gordon Lauren (New York, NY: The Free Press, 1979), 61-3.

[37] King, Keohane, and Verba, *Designing Social Inquiry: Scientific Inference in Qualitative Research*, 226-8. See also Alexander L. George and McKeown, "Case Studies and Theories of Organizational Decision Making," *Advances in Information Processing in Organizations* 2 (1985).

[38] See, for example, James D. Fearon, "Counterfactuals and Hypothesis Testing in Political Science," *World Politics* 43, no. 2 (1991); Niall Ferguson, ed., *Virtual History: Alternatives and Counterfactuals* (New York, NY: Basic Books, 1999); Richard Ned Lebow, "What's So Different About a Counterfactual?," *World Politics* 52, no. 4 (2000); Philip E. Tetlock and Aaron Belkin, eds., *Counterfactual Thought Experiments in World Politics: Logical, Methodological, and Psychological Perspectives* (Princeton, NJ: Princeton University Press, 1996).

The print media coverage has been limited to Dagens Nyheter, Sweden's largest broadsheet, and, for the external perspective, The Financial Times. The Financial Times was chosen on the grounds that it had the best access to the policymakers during the crisis.

In focusing on elite interviews, there is always the problem of access.[39] Important people have limited time and, in the case of the Swedish financial crisis, many of the key individuals have already both personally written and/or given multiple extensive interviews to media and academics. Among the negative responses received it was clear that financial crisis fatigue was a factor in the decision not to be interviewed. Fortunately, in the cases were access was denied, there were memoirs available to give an idea of that person's perspective.

Another problem in relying on interviews is the time frame between the financial crisis and the present. Since more than a decade has passed since the Swedish financial crisis, it would be strange if it had not led to some distortions in the understanding of the event. For example, a few of the interviewees explicitly mentioned the problem of remembering what days certain things happened and who did what. However, the interviews were not primarily carried through for data-collection purposes, but rather to understand the reasoning, priorities, and perceptions of the participants. Some of the interviews led to new leads and clarifications that improved my understanding of the time and setting of the financial crisis decision-making.

With both memoirs and elite interviews there are potential problems with the substance of the accounts. Obviously, they are valuable opportunities for setting the interviewee's personal record in a positive light and reconstructing events to legitimate and justify actions. The mind seems to be primed to remember and expand on the good deeds and forget and brush over the bad ones. However, in interviewing both members of the government and the opposition and cross-checking the accounts with media and secondary sources, this deficiency is, if not rectified, at least diminished.

1.5. The argument in brief

This study begins with the argument that the last few decades there have seen a tremendous growth in global financial flows and networks. The sheer number and scale of financial transactions have far outpaced the growth of merchandise trade and direct investment. These financial flows now also extend further around the globe and involve more actors than ever before, although most of this financial interaction still takes place within the developed world. Technological and institutional developments have also increased the speed with which financial transactions take place and triggered further financial innova-

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[39] My approach to the elite interviews is informed by Lewis Anthony Dexter, *Elite and Specialized Interviewing* (Evanston: Northwestern University Press, 1970).

tion. This has led to diversification of both the instruments and markets available to financial actors on a global scale.

The globalization of finance has had a significant impact on the environment in which states operate. Increasing capital mobility has influenced or even forced states to adapt economic policies to the new circumstances. In the Swedish case, the deregulation of the financial market was a late response to both the increasing technical difficulties in controlling capital in a globalizing economy and the need to modernize the financial sector to improve the potential for economic growth. The deregulation opened the Swedish economy to the constraints and impacts of global finance, and was one important cause for the Swedish financial crisis. Policymakers were inadequately aware of the risks of deregulation and failed to take precautionary measures to avoid the financial crisis.

This thesis uses the Swedish financial crisis of 1992 to assess the impact of global finance on the state. In the crisis, the government decided to support the banks, defend the currency, and build a political coalition to sustain its economic policies. The state had differing success rates in defending economic policy autonomy in these decisions. Based on an analysis of the global constraints, policy options and choices, this study argues that the Swedish state still had options available for economic policy despite the global constraints imposed on it during the financial crisis. Global constraints narrowed both the policy options and the time available for policymaking, although not to the extent that there were no options. As the space for policy choice narrowed, it became important to defend the remaining policy space. 'The increasing impact of global finance has forced policymakers to adapt and re-evaluate policy options in the light of the dynamics in the transforming environment. In this respect, the Swedish financial crisis became an important learning process for policymakers, and introduced the global financial flows and speculative attacks as constraints that policymakers have to factor into their calculations of different policy options. As policymakers became aware of the risks involved in financial crises, they set-off a chain of events increasing the preparedness, defences and resilience of the Swedish financial sector.

1.6. The organization of the study

This study is organized as follows. Chapter Two reviews the literature on the impact of globalization on the state and relates the theories to the Swedish financial crisis. The analysis finds the conventional theories inadequate to understand the global constraints and the policy options for a state during a financial crisis, and suggests a theoretical perspective of constrained choice for the state.

Chapter Three reviews the growth of global finance both globally and in the Swedish context more specifically in order to establish both the general transformation and the Swedish economy's participation in this trend. The chapter finds that Swedish financial markets were deregulated rather late in comparison with other OECD countries, but that Sweden now is one of the most financially open countries in the world. The Swedish economy is vulnerable to both the volatility and crises characterizing contemporary global finance.

Chapter Four analyses the causes and consequences of the Swedish financial crisis, framing the crisis in the context of global finance. The chapter argues that it was the conjuncture of structural economic problems with specific domestic policy measures, international events and speculation that triggered the crisis. Apart from severe economic repercussions, the financial crisis led to economic policy changes, increased crisis consciousness, and measures to improve the resilience of the financial sector in Sweden.

Chapter Five identifies three key decisions in responding to the financial crisis and assesses the decisions through the lenses of the theoretical approaches outlined in Chapter Two. The analysis finds these theoretical approaches wanting. The chapter argues that the suggested constrained choice approach improves our understanding of the impact of global finance on state policy during the Swedish financial crisis.

Chapter Six identifies and assesses global constraints imposed on the Swedish state during the financial crisis of 1992. The chapter finds both material and ideational constraints operating and influencing the policymakers in the three key decisions. However, the evidence found of global constraints suggests that they are indirect varying over time and circumstance, rather than being constant and deterministic.

Chapter Seven assesses the issue of policy options in the key decision of the Swedish financial crisis. The chapter finds that the Swedish state had options available to it in all three policy decisions. The chapter then analyses why a specific policy option was chosen in each of the three decisions and finds that the government approached the environment differently with respect to the three key decisions.

Finally, the concluding chapter of the thesis summarizes the findings and draws out the implications of the study for further research on the impact of globalization on state policymaking.

Chapter 2: Globalization, the State, and the Financial Crisis in Sweden

2.1. Introduction

In the heated debates on globalization that gained momentum with the end of the Cold War, one of the main strands concerns the impact of globalization on the state. The arguments have ranged from those of scholars who believe that globalization has had no impact on the state whatsoever to those who foresee the obsolescence of the state as a consequence of increasing globalization. The definitions of globalization and of the state are contentious and this has frustrated progress beyond conceptual interpretation. In order to explore the impact of globalization beyond the conceptual trenches, the definition used here leans on Scholte's argument that globalization is "the growth of 'supraterritorial' relations between people."[1] This conception of globalization acknowledges that social relations and transactions take place beyond territory, but it also acknowledges that states and territory still matter. While a multitude of fuzzy definitions of globalization exist, the opposite is true for the state. The state is usually an abstraction taken for granted without definition. Here the state is defined organizationally and refers to a set of territorially based governmental institutions.[2] As supraterritorial relations have grown, the relevance and capacity of these territorially based governmental institutions have come increasingly under pressure. Supraterritorial relations have grown in many areas, but are perhaps most distinctive in financial matters. Therefore, the most serious challenge to the state is likely to come in this area.

The challenge of global finance and its impact on the Swedish state will be the focus of coming chapters. The purpose of this chapter is to trace the development of theoretical thinking regarding the impact of globalization on state autonomy and capacity and to set out the perspective in this dissertation based on this body of theoretical work. In general terms, the theoretical discussion centres on four arguments about globalization and the state. One strand of thinking focuses on globalization and the retreat or decline of the state. Strange

[1] Scholte, *Globalization*.

[2] According to Dunleavy and O'Leary, there are five characteristics of a modern state. The state is (1) a set of institutions separable from the rest of society; (2) sovereign within its territory; (3) The state extends its sovereignty to all individuals within its territorial boundaries; (4) The state is organized and managed bureaucratically and (5) it has the capacity to tax its population.Patrick Dunleavy and Brendan O'Leary, *Theories of the State: The Politics of Liberal Democracy* (Basingstoke: Macmillan Press, 1987), 1-3.

is one of the main proponents of this line of argument.[3] The counterpoint to this argument is that globalization has no impact on states. One of the most prominent scholars pursuing this line of argument is Krasner.[4] These two arguments are extremes in the theoretical discussion on globalization – either globalization means everything or it means nothing. In between these outliers, it is possible to locate two general arguments. One of them claims that globalization has forced the state to adapt. Cerny has made notable contributions to this line of thinking.[5] The other claims that the state, although constrained, still has policy choice. Garrett is one of the foremost proponents of this line of argument.[6]

These four perspectives and the approach of this dissertation are the basis for the structure of this chapter. The sections analyse, in order, the arguments of globalization and state decline, the insignificance of globalization as it pertains to the state, globalization and forced state adaptation, and globalization and state policy choice. Lastly, there is a section that outlines the perspective in this dissertation. This chapter will of course not give full credit to all the details of proponents and opponents of certain arguments. However, even if the chapter structure is somewhat rough, it will provide a view on the scope and development of the literature on the subject matter in order to locate this dissertation within the literature and provide the stepping stone for assessing the impact of global finance on economic policy in Sweden.

The perspective pursued in this dissertation is that globalization has constrained the state, but that there are policy options open even for smaller states to forge their own futures. Globalization has changed the playing field and states will have to find coping strategies to reduce their vulnerability and carve out room for manoeuvre in order to preserve their autonomy. Within the broad discussion of the impact of globalization on state autonomy, this perspective lies somewhere between the forced adaptation and the policy choice arguments.

2.2. Arguments of globalization and state decline

Since the globalization discourse took off in the 1970s, it has been a common claim that the world has entered a new global era characterized by a level of integration of national economies previously unseen. The shift has been so profound, some scholars claim, that it has fundamentally restructured the "frame-

[3] Susan Strange, *The Retreat of the State: The Diffusion of Power in the World Economy*, Cambridge studies in international relations, 49 (Cambridge: Cambridge University Press, 1996).
[4] Stephen D. Krasner, "International Political Economy: Abiding Discord," *Review of International Political Economy* 1, no. 1 (1994).
[5] Philip G. Cerny, *The Changing Architecture of Politics: Structure, Agency, and the Future of the State* (London: Sage Publications, 1990).
[6] Geoffrey Garrett, "Global Markets and National Politics: Collision Course or Virtuous Circle?," *International Organization* 52, no. 4 (1998).

work of human action"[7] and this spells the decline of the state. The primary drivers of this shift are commonly understood as changes in technology and capitalism.[8] This has led to increasing mobility of goods and finance, and only to a lesser extent of labour. The high factor mobility has levelled the playing field for firms and transformed separate national markets into one common market.[9] This has increased economic efficiency and economies of scale, but also triggered a so-called 'race to the bottom'. When corporations and capital continuously search for competitive advantage in a global market, they can effectively drive down the factors they want to minimize. With the threat of exiting a country with higher costs, they can induce a policy change decreasing, for example, taxes, labour costs, and environmental regulations.[10] In the process, national governments lose their ability to shape the future of their national economies and the decline of the state ensues. The de-nationalization of economic and political power makes the state in effect "a transitional mode of organization for managing economic affairs."[11] When capital can locate wherever economic advantage dictates and labour still is nationally located, the argument goes, labour will have to adjust to meet the new pressures of competition. This threatens particularly states with large welfare states and extensive labour rights, and forces national monetary and fiscal policies to align with the expectations of transnational companies and global markets.[12]

This line of thinking has been put forth by many academics and analysts and they are sometimes labelled "globalists"[13] or "hyperglobalists"[14]. The proponents of the state decline argument encompass a diverse group, including both neoliberals and Marxists. They have largely agreed on the drivers of state decline and they are sceptical about the state-centrism of Realism. Where they have differed is in their emphasis on where this process will take us and what the normative implications will be. This line of thinking appeared long before globalization became a buzzword. For example, the economic historian, Charles Kindleberger, took the developments in the marketplace to their logical extreme already in 1969, when he proposed that "the nation-state is just about through

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[7] Martin Albrow, *The Global Age: State and Society Beyond Modernity* (Cambridge: Polity Press, 1996), 85. Quoted in David Held and others, *Global Transformations: Politics, Economics and Culture* (Cambridge: Polity Press, 1999), 5.
[8] Held and others, *Global Transformations*, 10.
[9] Robert Wade, "Globalization and Its Limits: Reports of the Death of the National Economy are Greatly Exaggerated," in *National Diversity and Global Capitalism*, ed. Suzanne Berger and Ronald Dore (Ithaca, NY: Cornell University Press, 1996), 61.
[10] Debora L. Spar and David B. Yoffie, "A Race to the Bottom or Governance from the Top," in *Coping with Globalization*, ed. Aseem Prakash and Jeffrey A. Hart (London: Routledge, 2000), 31.
[11] Kenichi Ohmae, *The End of the Nation State* (New York, NY: The Free Press, 1995), 149.
[12] Paul Hirst and Grahame Thompson, "Globalization and the Future of the Nation State," *Economy and Society* 24, no. 3 (1995): 414.
[13] Scholte, *Globalization*, 17.
[14] Held and others, *Global Transformations*, 3-5.

as an economic unit."[15] However, the popularity of this approach peaked in the aftermath of the Cold War. As the bipolar rigidities of the international system began to dissolve, those hopeful of a new world order gained confidence and many regarded the state as obsolete after this fundamental change. One who voiced the euphoric spirit of the time was the ubiquitous management guru of the early 1990s, Kenichi Ohmae. He was bold enough to claim that "the nation state has become an unnatural, even dysfunctional, unit for organizing human activity and managing economic endeavor in a borderless world."[16] The draw of the argument was even strong enough to refurbish geopolitics into geoeconomics, and strategists, such as Edward Luttwak, pitched in by coining a new word, "turbo-capitalism", for the process claiming that "the most obvious cause of accelerated structural change (turbo-capitalism) is the worldwide retreat of the state from the marketplace."[17] From a more academic perspective, Strange is the most notable proponent of this argument. Her view is that "the authority of governments of all states, large and small, has been weakened as a result of technological and financial change and of the accelerated integration of national economies into one single global market economy."[18] The consequence is that "state authority has leaked away, upwards, sideways, and downwards. In some matters, it seems to have gone nowhere, just evaporated."[19]

In relation to the financial crisis in Sweden, a proponent of this argument would probably take the position that Sweden was a prime example of a state in decline. Indeed, the financial crisis and the economic problems were severe enough in the early 1990s that scholars argued that Sweden suffered from "suedosclerosis."[20] According to Gilpin, it has been a common belief in the aftermath of the financial crisis that struck Europe and Sweden in the early 1990s that this "demonstrated the triumph of transnational economic forces and economic globalization over the nation-state."[21] During the financial crisis, Sweden was unable to defend its economy and population from the onslaught of the global financial market. Sweden's failed attempt to defy the attacks of currency speculators in the autumn of 1992 falls neatly in line with the argument of state decline. From this perspective, the pressures exerted by the rise of global finance and increasing capital mobility forced Sweden to give in to the will of the market during the financial crisis and this led to the retreat of the Swedish state.

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[15] Kindleberger, *American Business Abroad*, 207.
[16] Kenichi Ohmae, "The Rise of the Region State," *Foreign Affairs* 72, no. 2 (1993): 78.
[17] Edward N. Luttwak, *Turbo-Capitalism: Winners and Losers in the Global Economy* (New York, NY: HarperPerennial, 2000), 37.
[18] Strange, *The Retreat of the State*, 13-4.
[19] Susan Strange, "The Defective State," *Daedalus* 124, no. 2 (1995): 55.
[20] Ingemar Ståhl and Knut Wickman, *Sudeosclerosis: The Problems of the Swedish Economy*, trans. Kerstin Tanner and Roger Tanner (Stockholm: Timbro, 1995).
[21] Robert Gilpin, *Global Political Economy: Understanding the International Economic Order* (Princeton, NJ: Princeton University Press, 2001), 36.

As a result, Sweden now dances to the tune of the financial markets and the increasingly irrelevant Swedish state is bound to fade away.

The main contribution of this argument is that it challenges the state-centric orthodoxy in International Relations. This makes it controversial and ties it into the perennial debate on the pros and cons of Realism. Cohen, for example, observes that "the notion of a sovereign territorial state as an accurate representation of political reality has come under increasingly critical scrutiny."[22] This argument also made it clear that the state is only one among many actors able to influence world affairs and this implies further attention to non-state actors. Strange, for example, makes this point when she argues that "depending on the issue, it may be that banks or the oil companies, or the drug barons of Colombia, or large multinational enterprises are just as important as states in determining who-gets-what questions that have always lain at the centre of the study of politics."[23] Otherwise, this argument is marginal beyond providing the reliable straw man and sounding board that triggered many scholars to analyse and further our understanding of the process of globalization. At its peak in the early 1990s, the attraction of this argument was of course that the rapid expansion of economic globalization seemed to be happening and this provided the impetus for change. Proponents of this argument spotted structural change and extrapolated the consequences of it for the state. The alarming consequences outlined for the state rallied creative minds and brought attention to this issue.

The main weakness of this argument is that it makes a linear extrapolation of what over a short time period seems to indicate declining state authority and concludes that this is the end of the state. However, globalization is a complex process and there are both positive and negative consequences of globalization. The argument overstates the negative consequences of globalization on state authority. Over time, globalization may strengthen state authority depending on how the state handles the challenge. For example, new technologies could be the beginning of a surveillance state of Orwellian proportions, where nothing escapes the state.[24] Related to the extrapolation problem is the static notion of the state. As Scholte points out, "not all states have been affected by and responded to transborder capitalism in the same way."[25] There is great diversity among states, when it comes to history, resources, institutions, and so on. Different states have different roles, tasks, and priorities to fulfil. The state is a dynamic body that through history has adapted to changing circumstances and not all states react in a similar fashion to the same stimuli. Globalization may have weakened state authority in some respects, but not necessarily in all.

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[22] Benjamin J. Cohen, *The Geography of Money* (Ithaca, NY: Cornell University Press, 1998), 15.

[23] Strange, *The Retreat of the State*, 68.

[24] Stephen Gill, "The Global Panopticon? The Neoliberal State, Economic Life, and Democratic Surveillance," *Alternatives* 2, no. 1 (1995).

[25] Scholte, "Global Capitalism and the State,": 440.

This argument allows only limited or no room for state agency. For example, the organization and work of governmental institutions, the skills of the people in government, and the creation of an international regime could make a difference in either reinforcing state authority or stopping the decline of the state. Therefore, the argument is overstating its case, close to being deterministic, and unnecessary alarmist. Furthermore, the argument does not recognize that the state itself is an important factor in the process of globalization. As Gill and Law put it, "capital needs the state to provide public goods, including law and order… it inevitably requires direct coercive action by the state."[26] Capitalism would not work without the services provided by the state. Helleiner, for example, shows that the state provided market operators with more freedom and refrained from introducing more effective capital controls and thus facilitated the process of globalization.[27] Thus, states are neither "victims of the market economy"[28] nor are they increasingly finding themselves "hostages of financial market sentiment"[29]; they are, rather, accomplices in the process. This would mean that states have the opportunity to reverse the process of globalization.[30] In all, there are many problems with this argument. Mann sums up the problems for the globalists well: "With little sense of history, they exaggerate the former strength of nation-states; with little sense of global variety, they exaggerate their current decline; with little sense of their plurality, they downplay inter-national relations."[31] However, this does not necessarily mean that the state decline is out of the question. As Evans argues, "while the eclipse of the state is a possibility, it is not a likely one."[32]

2.3. Arguments about the insignificance of globalization

The counterpoint to the previous state decline argument is that globalization has had very limited, if any, impact on the state. Globalization has transformed neither the state nor the international system. In the still anarchic international system, proponents of this argument claim, both the control and authority of

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[26] Stephen Gill and David Law, "Global Hegemony and the Structural Power of Capital," in *Gramsci, Historical Materialism and International Relations*, ed. Stephen Gill (Cambridge: Cambridge University Press, 1993), 116.
[27] Helleiner, *States and the Reemergence of Global Finance*.
[28] Strange, *The Retreat of the State*, 14.
[29] Benjamin J. Cohen, "Phoenix Risen: The Resurrection of Global Finance," *World Politics* 48 (1996): 286.
[30] Helleiner, "Post-Globalization,".
[31] Michael Mann, "Has Globalization Ended the Rise and the Rise of the Nation-State?," *Review of International Political Economy* 4, no. 3 (1997): 494.
[32] Peter Evans, "The Eclipse of the State? Reflections on Stateness in an Era of Globalization," *World Politics* 50, no. 1 (1997): 64.

states face continuous challenges.[33] Globalization is only one of many challenges, and it is not likely to change the structural framework of the international system. Therefore, proponents of this line of argument regard globalization as an insignificant phenomenon on a structural level. It is business as usual in International Relations. These so-called 'ultra-sceptics' of the globalization thesis argue that states always have operated in an integrated international environment. From their perspective, the 'hyperglobalists' have created a mythical past and on this basis, they exaggerate the degree of change that has taken place. According to some proponents of this argument, globalization is apparent in increasing international flows of goods, money, ideas and people.[34] This has had some impact on state control, but it is a traditional challenge that states have had to deal with before. There is no qualitative difference in the present challenge of globalization, because flows of goods, money, ideas and people have waxed and waned through history and the evidence on the present increase does not constitute or suggest a decisive change from this pattern. The impact of globalization is, thus, neither sufficient to conclude the transformation of the state nor historically significant. Rather than globalization spelling the decline of the state, proponents of this argument perceive the opposite. As globalization has increased so has state activity.[35]

The most prominent scholar to make this argument is probably Krasner. He argues, for example, that globalization does not challenge juridical sovereignty and that state control actually has increased over time.[36] In his view,

> Globalization has challenged the effectiveness of state control; although it is not evident that contemporary challenges are qualitatively different from those that existed in the past. Globalization has not, however, qualitatively altered state authority which has always been problematic and could never be taken for granted.[37]

Many other sceptics have tried to puncture the myth of globalization. For example, Hirst and Thompson argue that "globalization is above all a literature of anecdote, inference and reliance on the accumulation of isolated facts removed from context."[38] Zysman claims that due to globalization, "the possibilities of national governments to influence the course of growth and development are redefined, but nations will retain a central place in an ever more interconnected

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[33] Stephen D. Krasner, "Globalization and Sovereignty," in *States and Sovereignty in the Global Economy*, ed. David A. Smith, Dorothy J. Solinger, and Steven C. Topik (London: Routledge, 1999), 34.
[34] Stephen D. Krasner, ed., *Problematic Sovereignty: Contested Rules and Political Possibilities* (New York, NY: Columbia University Press, 2001), 36.
[35] Ibid., 40.
[36] Krasner, "Economic Interdependence and Independent Statehood," 318.
[37] Krasner, "Globalization and Sovereignty," 34.
[38] Paul Hirst and Grahame Thompson, *Globalization in Question*, 2d ed. (Cambridge: Polity Press, 1999), xiii.

and homogenous economy."[39] Wade expresses another common view among the sceptics when he claims that "the world economy is more inter-national than global."[40] Another common criticism of the globalists is that the integration of the world economy was higher at earlier points in time. In this vein, Weiss argues that "the international economy was much more open in the pre-1914 era than at any subsequent time."[41] Sceptics also claim that the state is a prerequisite for globalization. They point out, for example, that "globalization was restored by military force and national policy; it was not a 'natural' state of affairs."[42] Therefore, the process of globalization requires protection by state power. From this perspective, globalization is a buzzword that will go away long before the state.

A proponent of this perspective would probably view the Swedish financial crisis of 1992 as a regular economic crisis that the state had to deal with in the same way that it has dealt with economic crises before. The small open Swedish economy is vulnerable to shifting circumstances in the international economy, but this has been the case for a long time and the situation this time is not qualitatively different. Sweden has managed situations of increasing financial flows like this before and will do it again. Furthermore, the causes of the crisis were primarily homegrown and an outcome of the economic problems Sweden ran into in the 1970s. Previously, Sweden had deflated the krona to restore productivity, but now chose to hold on to the fixed krona. Sweden also decided to deregulate its financial market in order to boost productivity and therefore voluntarily gave up some control, while never relinquishing any authority. Thus, Sweden got itself into the situation, had to suffer the consequences, and had to manage the reform of the economy. Globalization was insignificant for the Swedish financial crisis.

The main contribution of this argument is its sobering influence on the most enthusiastic globalists. In scrutinizing and questioning the validity of the evidence of globalization and the state decline argument, this argument contributed to the understanding of the process of globalization. This approach rectified the lack of historical perspective in the globalist approach. As Gilpin points out, "those individuals who argue that globalization has severely limited economic sovereignty appear to believe that governments once possessed unlimited national autonomy and freedom in economic matters."[43] From a realist

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[39] John Zysman, "The Myth of a 'Global' Economy: Enduring National Foundations and Emerging Regional Realities," *New Political Economy* 1, no. 2 (1996): 157.
[40] Wade, "Globalization and Its Limits," 61.
[41] Weiss, *The Myth of the Powerless State*, 171.
[42] Paul Hirst and Grahame Thompson, "The Future of Globalization," *Cooperation and Conflict* 37, no. 3 (2002): 249.
[43] Robert Gilpin, "The Retreat of the State?," in *Strange Power: Shaping the Parameters of International Relations and International Political Economy*, ed. Thomas C. Lawton, James N. Rosenau, and Amy C. Verdun (Aldershot: Ashgate, 2000), 210.

viewpoint, this line of argument was necessary and successful in bringing back and refocusing the discourse in International Relations on the issues regarded as important, i.e. anarchy, power, the state, and inter-state relations.

One major weakness of this approach is the use of the globalization and state decline argument as a straw man in order to reconfirm the primacy of realist thought. From incomplete and poor evidence, this argument extrapolates that there is complete continuity for the state. The globalists made the same mistake when they predicted complete change. The problem with the evidence is the very limited availability of global statistics. Territorial states are still the basis for most data collection.[44] Where the globalist would overlook history, the sceptics are uncritical of historical sources and draw far-reaching conclusions from the limited and biased statistics available prior to 1914. The irony of this argument and its attempt to refute the evidence of globalization is of course that it has sustained the buzz around the concept, rather than making it go away. Had there been nothing new about globalization, interest would have atrophied as scholars tired of the 'myth' and pursued their search for a better understanding of world affairs elsewhere.

2.4. Arguments about globalization and forced state adaptation

In between the arguments posed by hyperglobalists and ultra-sceptics, one of the major approaches claims that globalization has forced state adaptation. This approach is not as certain about the dysfunctonality and obsolescence of the state as the state decline thesis, but recognizes that the process of globalization has forced the state to adapt to new circumstances. Globalization of both state structures and structures of capitalism has changed the interaction between structure and agency. This has forced a shift in the focus of state intervention from "forms which 'decommodify' those activities pursued by the state…to those which 'commodify' or 'marketize' both state economic activities *and other elements of state structure too*."[45] There has been a paradigmatic shift from the welfare state to what Cerny calls "the competition state."[46] The basis for the welfare state was the post-World War II compromise to allow the state to shelter, regulate and intervene in the domestic economy in order to create stability, while simultaneously allowing and negotiating a multilateral trading regime based on free trade.[47] The goal was to gain domestic stability while extracting the benefits generated from an open trading regime. This compromise began breaking down in the 1960s due to the increasing cost of the state, growing ex-

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[44] Scholte, *Globalization*, 19-20.
[45] Original emphasis. Cerny, *The Changing Architecture of Politics*, 53.
[46] Ibid.
[47] Ruggie famously called this embedded liberalism.John Gerard Ruggie, "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order," in *International Regimes*, ed. Stephen D. Krasner (Ithaca, NY: Cornell University Press, 1983), 209-14.

ternal trade, and increasing cross-border financial transactions. The consequence was increasing difficulties for the welfare state to insulate its domestic economy from the global economy.[48] As the problems for the welfare state mounted, it tried to remedy the situation through commodification and marketization of economic activities to lower the burden of the "overloaded state."[49] The welfare state could not manage its many tasks efficiently and needed more flexibility, and was therefore forced to shed tasks. Cerny sums up the bottom-line of this argument and main difference with the view of globalists and ultra-sceptics, when he claims, "The nation-state, of course, is not dead. But its role has changed."[50]

The outline of this argument focused on Cerny's competition state thesis, but others make similar arguments. For example, Jessop claims that the social reproduction regime has shifted from Fordism to post-Fordism.[51] This shift entailed the new primacy of labour market flexibility and international competition over social policy. Under the pressure of global capital, the Keynesian welfare state had to adapt and it gave way to the "Schumpeterian workfare regime."[52] The state remains politically significant, but its capacities have weakened to the extent that there has been a "hollowing out" of the state.[53] Another scholar that makes a similar argument, although from a very different vantage point, is Burnham. He argues that the global political economy is about "reorganising (rather than bypassing) states and this recomposition is undertaken actively by state managers as part of a broader attempt to restructure, and respond to, a crisis of labour-capital relations."[54] The point is that governments actively have depoliticized many tasks that used to be politicized.[55] From this radical perspective, state adaptation was induced internally and had similar effects at least across the Western world. The drivers were different for state adaptation, but the effect was similar to that of the competition state thesis. Another scholar who makes a strong case for forced state adaptation is Andrews. He argues that capital mobility is a structural feature of the international system and imposes constraints on states in the same fashion that, for example, bipolarity imposed constraints on the state during the Cold War.[56] Thus, capital mobil-

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48 Philip G. Cerny, "Globalization and Other Stories: The Search of a New Paradigm for International Relations," *International Journal* 51, no. 4 (1996): 634.
49 Philip G. Cerny, "Paradoxes of the Competition State: The Dynamics of Political Globalization," *Government and Opposition* 32, no. 2 (1997): 262.
50 Ibid.: 269.
51 Bob Jessop, "Post-Fordism and the State," in *Comparative Welfare Systems: The Scandinavian Model in a Period of Change*, ed. Bent Greve (Basingstoke: Macmillan Press, 1996), 167.
52 Ibid., 176.
53 Ibid., 177.
54 Peter Burnham, "The Politics of Economic Management in the 1990s," *New Political Economy* 4, no. 1 (1999): 41.
55 Ibid.
56 David M. Andrews, "Capital Mobility and State Autonomy: Toward a Structural Theory of International Monetary Relations," *International Studies Quarterly* 38, no. 2 (1994): 197-8.

ity forces states to adapt by punishing or rewarding state action and states have found the punishment too hard or the reward too sweet to resist deregulation.

Proponents of this approach would probably view the Swedish financial crisis as a good example of how globalization forced Sweden to adapt despite political will and domestic pressures to the contrary. Sweden's refusal to adapt to the new circumstances alerted global market actors, who then proceeded to challenge the government. The Swedish government believed that it still had the clout to uphold its commitments in the marketplace. When pushed to the limit, including marginal interest rate hikes up to 500 percent and depletion of exchange rate reserves, the Swedish government caved in and started a serious revamping of the Swedish welfare state. The broad cross-partisan consensus on a neoliberal program to please the market proposed at the peak of the financial crisis showed the lack of alternatives available to the state and signalled that a government of any colour would prioritise the expectations of the market before the expectation of the population. In the aftermath of the crisis, Sweden had to conform to the competition state thesis. With reference to Sweden, Moses argues that "a new international economic regime, characterized by increased levels of capital mobility, has made traditional tools for government steering ineffective."[57] This makes all participants "subject to an iron law of policy."[58] The domestic economy is now continuously adapting to the tune of globalization. Furthermore, the rather reluctant and gradual deregulation of the Swedish financial market, which will be the topic of next chapter, was from this perspective a sluggish response to increasing globalization. The state actively took part in deregulating the financial market, but did not foresee the full effect of turning Sweden from a welfare state into a competition state. Sweden did not preemptively adapt to the new circumstances but had to be disciplined by the market.

The major contribution of this argument is that it makes a strong case that an important development has taken place in the international system. The interaction of structure and agency forged the adaptation of the state. Globalization and in particular the rise of global finance have brought qualitative and quantitative change both to the system and actors at different levels within the system. The border between national and international has broken down. In this process, the state had to adapt. This approach explains the constraints and pressures for the state to adapt in a certain direction, which in turn explains why the price of diverging from the new norms seems too high for most states. Another contribution of this argument is the inclusion of other actors than the state. As the power of non-state actors, below and above the state level, has increased, new pressures and constraints on state and governance have emerged.

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[57] Jonathon W. Moses, "Abdication from National Policy Autonomy: What's Left to Leave?," *Politics & Society* 22, no. 2 (1994): 142.
[58] Ibid.

For example, companies and individuals now easily circumvent the state to interact with other actors and this loss of control has transformed the role of the state.

A major problem with the competition state thesis and similar lines of argument is that proponents specify the characteristics of what constitutes a competition state poorly. Therefore, it is hard to operationalize and test the evidence that the shift to the competition state has taken place and that the construct exists. The theoretical proposition is not sufficiently backed up with empirical evidence. Although, the competition state thesis has an intuitive and anecdotal appeal, it is very hard to prove that it is correct. Many activities are still 'decommodified,' 'de-marketized,' and 'politicised'. The proponents never specify the breaking point when a welfare state becomes a competition state. If the size of the state as percentage of GDP diminishes from 60% to 55%, is it fair to talk about a hollowing out of the state? Another problem with the competition state thesis, related to this, is that the states within, for example, the EU are still so different when it comes to both size and spending on welfare. The Anglo-Saxon experience is very different from the one in mainland Europe. Indeed, the interesting research question seems to be why states have not adapted and converged further to the forces of globalization.

The competition state thesis is also deterministic. For example, Cerny claims that "the genie is out of the bottle and that states are seeing their policy capacity and political autonomy eroding in a way which cannot be recuperated."[59] It seems more likely that this is a question of political will. For example, Goodman and Pauly argue that new capital controls are not impossible, only that such a movement would be costly from the state's point of view. As they put it: "The restoration of controls is not just a theoretical possibility."[60]

2.5. Arguments about globalization, state autonomy and policy choice

There is another line of argument located in between the hyperglobalists and ultra-sceptics. Garrett is a leading proponent of this perspective, which claims that globalization has imposed limited constraints on state autonomy, but that there still is ample room for policy choice. As in other perspectives attributing an impact to globalization, this approach perceives the constraints on the policy autonomy of the state through primarily three mechanisms. They are trade competitiveness, multinationalization of production, and integration of financial markets.[61] However, this approach views these mechanisms of policy constraints as both weaker and less pervasive than commonly taken for granted in the other perspectives. For example, there is neither clear-cut evidence of a pol-

[59] Cerny, "Globalization and Other Stories,": 634-5.
[60] John B. Goodman and Louis W. Pauly, "The Obsolescence of Capital Controls? Economic Managment in an Age of Global Markets," *World Politics* 46, no. 1 (1993): 51.
[61] Garrett, "Global Markets and National Politics,": 791.

icy race to the bottom nor capital flight in countries whose governments have intervened in the market as predicted by globalists.[62] Therefore, there is more policy choice available for governments than both the state-decline and competition-state arguments would admit. The power of states may have decreased in certain areas but they still have instruments available to respond to globalization. Adaptation is not forced upon the state, but rather there is a choice for the state to deal with the positive and negative effects of globalization. The reason for the continued policy choice of governments is that "governments provide economically important collective goods – ranging from the accumulation of human and physical capital, to social stability under conditions of high market uncertainty, to popular support for the market economy itself – that are undersupplied by the markets and valued by actors who are interested in productivity."[63] In sum, globalization has constrained the state's policy options to an extent, especially in some areas such as finance, but there are still significant policy choices open for states to pursue.

Many scholars make arguments similar to Garrett's, but few have been as specific about the policy choices actually available to states. One influential contribution comes from Weiss. She is very critical of the globalists' exaggeration of the impact of globalization on the state. She thinks their problem is the assumption that the constraints on the state due to globalization are absolute, rather than relative, and that these constraints are definite rather than part of the ongoing evolution of states and state power.[64] Weiss also develops the concept of 'state capacity' and argues that domestic and global challenges have not undermined state capacity, but altered it.[65] As capacities of states differ, so does the ability to take advantage or succumb to the pressures of international economic change. Although there are variable opportunities for policy choice among different states, they can still find their own paths.

Another important contribution to this argument comes from Helleiner. He makes the case that states were vital in the process of financial globalization and refutes the notion that globalization would be beyond politics.[66] The constraints on state authority come from "offshore financial activity, changing regulatory practices and the deterritorialization of currency structures."[67] This will lead to an important restructuring of the state rather than the decline of the sovereign state. In arguing the potential reversal of financial globalization be-

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[62] Ibid.: 823.
[63] Ibid.
[64] Linda Weiss, "Globalization and the Myth of the Powerless State," *New Left Review*, no. 225 (1997): 13.
[65] Weiss, *The Myth of the Powerless State*, ch. 2.
[66] Helleiner, *States and the Reemergence of Global Finance*.
[67] Eric Helleiner, "Sovereignty, Territoriality and the Globalization of Finance," in *States and Sovereignty in the Global Economy*, ed. David A. Smith, Dorothy J. Solinger, and Steven C. Topik (London: Routledge, 1999), 154.

cause of state behaviour in times of financial crisis, Helleiner also shows that there is still plenty of room for policy choice for states.[68] In sum, differing domestic institutional arrangements, coping strategies, and capabilities of states are examples of intermediate variables bolstering and diversifying the impact of globalization and allowing states policy choice.

Proponents of this approach would focus on the fact that Sweden was able to get out of the financial crisis rapidly and restructure its economy. Sweden had not sufficiently adapted to the new constraints that financial deregulation imposed prior to the crisis and suffered the consequences of this failure. However, there were plenty of policy choices available and the policymakers soon managed to regain control of governmental spending, balance the budget, and restore the welfare state. There was some infringement on Swedish autonomy at the peak of the crisis, but this was not a surprise or unusual for a smaller state. Rather, the capacity and preparedness of a smaller open economy was an asset for the government in adapting to the post-crisis environment. Swedish policy choice has narrowed in some issue areas due to globalization, but there are still alternative policy routes to follow.

The main contribution of this argument is that it goes beyond the conception of the state as a unitary rational actor. All states have similarities but they are not necessarily the same. Therefore, states have their own specific problems with globalization and change. States participate in continuous action-reaction dynamics domestically, with external actors, and with structural change. There are not only structural constraints induced by globalization, but also agency to adapt to, exploit, or form these constraints. This approach acknowledges the diverse capacities and available responses among states. Milner and Keohane, for example, argue that "the impact of the world economy on countries that are open to its influence does not appear to be uniform."[69] Another contribution of this approach is its critical view of the evidence of the globalists. The scrutiny of the facts questions and reigns in the most enthusiastic globalists and develops the discussion on globalization further. In criticizing and tempering the evidence of globalization, this approach refutes the structural determinism of many other approaches.

A major criticism of this approach (and the previous approaches, too, for that matter) centres on choice. The proof of choice or no choice tends to be counterfactual. Even with the benefit of hindsight, it is difficult to discern whether there were alternative routes to follow for the government or if they faced a Hobson's choice. Did the policymakers perceive the decision as a choice at the time or did they unconsciously block out alternatives? Furthermore, poli-

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[68] Helleiner, "Post-Globalization," 206.

[69] Helen V. Milner and Robert O. Keohane, "Internationalization and Domestic Politics: An Introduction," in *Internationalization and Domestic Politics*, ed. Helen V. Milner and Robert O. Keohane (Cambridge: Cambridge University Press, 1996), 14.

cymakers have an incentive to portray their actions in the best of lights. If they have to implement unpopular measures, they will claim that external pressures forced them, while they are happy to portray themselves as the grand designers and facilitators of popular measures. Weiss has called this claim of impotence due to globalization "the political construction of helplessness."[70]

Choice can of course also be constrained by factors other than globalization. The most obvious one would be the organization of domestic politics. As Goodman puts it,

> Global financial structures affect the dynamics of national-policy-making by changing and privileging the interests and actions of certain types of firms. Once those interests have been embedded in policy, the movement back is not necessarily precluded but is certainly rendered much more difficult.[71]

Another problem with this approach is that it usually centres on the choice available to strong states in the OECD area, whereas the policy choice available for weak states in the developing world is unclear. This approach uses the state decline straw man set up by the globalists to make the rather trivial point that states have choice, when the interesting question is *what* choice they really have in the face of globalization.

2.6. Globalization, state constraints and policy choice

The previous sections have shown a wide variety of perspectives on the impact of globalization on the state and state autonomy. This broad spectrum of perspectives – ranging all the way from no impact of globalization on the state whatsoever to full impact and the imminent decline of the state – shows clearly how contentious this issue is and how plenty of scholars representing different academic disciplines, methodological outlooks, and ideological predilections have found it worthwhile to contribute to the discussion. This section aims to outline the perspective pursued in this dissertation and locate it within this broader spectrum of perspectives.

The approach in this dissertation maintains that despite the considerable impact of globalization, there is still policy choice for the state. In other words, the process of globalization has constrained policy choice and forced the state to adapt, but there is still enough room to manoeuvre for the state to respond to and cope with this challenge to its autonomy. With stricter limits imposed on policy choice, the remaining autonomy becomes more valuable for the state. While globalization has constrained the options available for the state, the actual choices matter more rather than less for the state. The state never existed in

[70] Weiss, *The Myth of the Powerless State*, 193.
[71] Goodman and Pauly, "The Obsolescence of Capital Controls?,": 52.

a vacuum and policy autonomy was never complete. However, the compression of time and space and increasing influence of supraterritorial phenomena entailed in the process of globalization expand and intensify the state's exposure to events beyond its reach. This exposure has had both positive and negative effects on the state. It has generated wealth, at least in many countries in the Western world, but also created new vulnerabilities and constrained policy choice for the state. Wealth generation emanates, for example, from liberalization, economies of scale, specialization, and market expansion. The new vulnerabilities are a function of higher stakes and less influence on the course of events. For example, developments in the global economy now influence a larger share of the domestic economy, which inevitably increases the stakes at hand. The stakes for the state have increased both in absolute and relative terms. Most OECD countries have grown wealthier due to globalization, which means that there is now more to lose if something goes wrong with the global economy. The loss can range from a lower standard of living to destitution in the country. Globalization and the breakdown of embedded liberalism have also made it more difficult for the state to shelter itself and the population from developments in the global economy and therefore the relative risk to losing is higher. At the same time, non-state actors have gained importance and jockey with states for positions of influence. Thus, globalization has both transformed and increased the vulnerability of the state and the population. With increasing vulnerability and limited policy autonomy, there is an urgent need to use the remaining policy autonomy to manage and, if possible, diminish the state's risk exposure in order to strengthen the resilience of the state and its population. Therefore, actual policy choice is more important in the present surge in globalization.

As policy choice has become more important, it is also more complicated because of globalization. The increasingly intertwined domestic and global economy has not only increased the exposure, but also made it more difficult to foresee the consequences of global developments on the domestic economy and, hence, to take precautionary actions. Complexity has increased because of more connections and the demise of the clear border between the domestic and global economy. For example, it is more difficult to estimate where, when, and how far the effects of a policy change will spread in a globally interconnected state. The knock-on effects are far-reaching and unpredictable. The risks of specific policy choices are also worse, since punishment is not only delivered at the election box every couple of years but also instantaneously on the market. The distribution of market punishment is prompt, but not necessarily fair or balanced. The higher stakes for the state have also made the stakes higher for policymakers and ultimately for the population. The policymakers' risk exposure and fear of failure give rise to a problem, similar to one often experienced in the financial market. Rather than making an independent judgement of the situation, it is safer and easier for policymakers to follow the same blueprint as other policymakers. For the particular policymaker, there is more to lose than to win from pursuing an independent policy that diverges from policies in similar states. If a policy goes wrong, he or she can claim that there was no actual policy choice and shift the blame to the elusive market. If it goes right, he or she can accept full accountability. Consequently, state autonomy and policy choice may appear more constrained than they really are, while the higher stakes have narrowed and complicated policy choice. Nevertheless, it is more important than ever to make sound policy choices, both to increase the state's resilience to developments in the global economy and to protect and possibly increase its remaining autonomy.

As will be argued in depth in the following chapter, this dissertation views the present surge of globalization as qualitatively and quantitatively distinct from previous surges in globalization. Although the globalists overstate their case and present an ahistorical account of the impact of globalization, it is not possible to dismiss the whole globalization discourse due to this lack of historical understanding. There are certainly similarities between the present and earlier periods of globalization and comparisons between different periods of globalization may be fruitful. However, from the perspective pursued here the present surge in globalization constitutes a specific challenge to the state and therefore demands a specific response from the state. Predictions of the decline of the state underestimated both the importance and adaptability of the state. Despite the fact that globalists were clearly wrong in declaring the decline of the state, that does not forever preclude the decline of the state. There seems to be more room for agency than some of the more deterministic approaches would admit.

Among the general arguments presented earlier in this chapter, the approach of this dissertation is located somewhere in between Garrett's argument of continuing policy choice and Cerny's argument of forced state adaptation. Garrett, on the one hand, is too sceptical of the impact of globalization and therefore overstates the scope of policy choice available. Cerny, on the other hand, argues that the impact of globalization is profound and thus overstates both the adaptation forced on the state and the constraints imposed on policy choice. In relation to Krasner's argument that globalization is irrelevant to the state, this dissertation agrees with his conclusion that the state has survived challenges before and probably will survive this one too. However, the argument diverges from Krasner in viewing the process of globalization as a challenge qualitatively and quantitatively different in comparison with previous challenges to the state. It is therefore not business as usual for the state and it is very likely that the relative positions of states will change due to their ability to handle this particular challenge. In comparison with Strange's argument, the view taken here concedes that the present process of globalization is something fundamentally new and therefore presents a challenge to the state previously unseen. However, this does not spell the end of the state per se, but forces it to adapt. The approach in this dissertation has borrowed strains from these four general arguments to build its own perspective. However, the point is to show empirically that the state can manage the new situation through the application of coping strategies. As mentioned earlier, globalization has put new demands on policymaking and it will take time to understand the new rules of the game. This dissertation aims to provide a perspective on this development.

Based on this theoretical perspective, the next chapter analyses the main trends and shifts in global finance and then relates the Swedish experience to this development. The purpose is to establish that the present surge of globalization has characteristics quantitatively and qualitatively distinct from previous surges in globalization and that Sweden has followed the world trend closely.

Chapter 3: The Growth of Global Finance in Sweden

3.1. Introduction

Over the last two decades there has been a huge increase in the flows of global finance. It is not only the number of transactions, but also the speed, scale, distance and area covered by these transactions that has thoroughly changed the impact and reach of global finance. Finance has gained a truly global reach and now influences the everyday lives and prospects of virtually everyone. The extent of this impact differs, of course, but even the most remote and secluded state or society has to grapple with at least the secondary or tertiary effects of global finance. The closer to the push and pull of the maelstrom of global finance a state or society is located, the more apparent the impact on politics and economics becomes.

The dual purpose of this chapter is to, first, map the main trends and shifts in global finance from the mid-1980s through the 1990s, and, second, to profile the Swedish experience of the trends and shifts in global finance. Global finance is defined here as transborder flows of credit, portfolio investment and savings. The first part of the chapter starts out briefly discussing the notion of globality as it relates to this work and then maps the trends. Indicators within the broad categories of financial openness and financial enmeshment will be used to establish the trends and shifts of global finance. These broad categories are an adaptation of those used to describe financial globalization by Held *et al.*[1] These categories will be discussed below. The second part of the chapter applies the same framework on the Swedish experience to establish whether Sweden follows the main trends in global finance or not, and to what extent the specific Swedish experience has diverged from the trends on the aggregate level.

Financial flows across borders have existed for centuries and there are many indicators to measure and map financial activity over time and space. Different scholars have, of course, used different approaches to capture the trends and shifts in global finance and there still is no standardized approach to describe the process. The present account has, of course, no pretension of providing the final say in this debate, but will rather provide one view of the broad trends in global finance. The debate on the best or most appropriate approach to measure the present rise of global finance and relate it to previous surges in cross-border financial flows will continue.

One illuminating approach in mapping the rise of global finance has been provided by Held *et al.* They distinguish between three broad categories of indicators to measure and understand the present rise of global finance and place it

[1] Held and others, *Global Transformations*, 189-90.

within a historical context. These categories are financial openness, financial enmeshment, and financial integration. Financial openness refers to, for example, the level of regulation and restrictions on cross-border transactions. Financial enmeshment refers to the extent of national financial engagement in global financial activity. This could be measured in a number of ways. One indication would be the involvement of both foreign financial institutions in domestic markets and domestic financial institutions in markets abroad. Another indication would be the turnover of foreign assets on national markets and national shares of global flows. Financial integration is the weakest and most problematic indicator in the framework of Held *et al.* Financial integration refers in their framework to the equalization of asset prices and returns between different national financial markets. The idea is that financial integration occurs when asset prices and returns equalize on identical assets. This equalization is a consequence of international capital mobility where arbitrage will force prices and returns to converge. They point out that few assets are identical, though, and a better measure would be the convergence of returns and prices on bundles of similar financial assets.[2] Still, if it is problematic to compare this indicator of financial integration in the present era of global finance, it is almost impossible to use it across earlier periods of financial globalization. This difficulty is probably the reason that Held *et al.* make only cursory use of this category in their chapter on shifting patterns of global finance.[3]

There are many scholars who highlight the complexity of financial integration. Weiss, for example, notes that there are three important trends that show that there is still a long way to go to achieve financial integration. Contrary to the predictions of the hyperglobalists, the cost of money has not converged, differences persist in savings and investment rates, and domestic investment is still mainly financed out of domestic savings. These unmet predictions go back to the dualism of financial markets. This dualism regards the differing cross-border mobility of assets in financial markets. Relative immobility applies especially to company shares because they tend to be listed on national stock exchanges. The currency, bond and futures markets are on the other hand genuinely transnational. Thus, there is a division in financial markets between the tangible (national/real) and intangible (borderless/symbolic) economy. Financial integration has taken place within these spheres rather than across them. Consequently, there is increasing disconnection between the product markets and financial markets and exchange rates would be a rare exception to this disconnection. There is also room for domestic institutions to exert a significant impact on domestic outcomes.[4] Goodman points out that, although the debate on the extent of financial market integration will continue, "nearly all agree that

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[2] Ibid., 189.
[3] Ibid., ch. 4.
[4] Weiss, *The Myth of the Powerless State*, 178-84.

the increase in both the size and turnover of financial flows has heightened the external constraint on domestic monetary policy-making."[5]

In this chapter, the framework outlined by Held *et al.* will be adapted to the extent that the category of financial integration will be excluded. For the above mentioned purposes of this chapter, it is not necessary to delve into the hair-splitting exercise of constructing bundles of similar financial assets to show the, at best, confusing results of potentially converging prices and returns. The point is not that financial integration does not matter or cannot be proven. The point is that it does not shed much light on the trends in global finance and that financial integration is not complete enough to leave states powerless. Furthermore, as Sinclair points out, there is no correspondence between the actual empirical parameters of international capital mobility and the model of perfect capital mobility. The explanation is that financial markets are social institutions where, for example, information, confidence, trust, and power relations distort the possibility for perfect capital mobility to be more than a theoretical model.[6]

3.2. The main trends in global finance

This section will first briefly discuss what is 'global' about global finance. Second, the section outlines the decisive regulatory moves that have increased financial openness in different areas. Third, this section charts financial flows to establish the trends in different areas of global finance and to show the increase in financial enmeshment. Finally, some of the qualitative changes in global finance will be discussed.

What is 'global' about global finance?

Just as globalization has been a much-contested word since the 1990s, so the 'global' in global finance has had its own bouts of academic controversy. The term globalization has been used very broadly and has taken on a multitude of meanings, such as internationalization, liberalization, modernization, and universalisation. As Scholte points out, these conceptions of globalization are all redundant in that they do not bring new insights. They are already sufficiently covered by their traditional concepts and hence there is no need to label them differently. He continues to point out that it is the supraterritorial characteristic of globalization that is new and analytically interesting to explore.[7] Globality (the condition of being global) and globalization (the process of becoming global) describe circumstances where territory is substantially transcended. Changing social spaces have significant consequences, as space is one of the

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[5] John B. Goodman, *Monetary Sovereignty: The Politics of Central Banking in Western Europe* (Ithaca, NY: Cornell University Press, 1992), 18.
[6] Sinclair, "International Capital Mobility," 96.
[7] Scholte, *Globalization*, 44-50.

basic dimensions of all social relations. The spatial setting of a society heavily influences and interacts with the economy, politics, culture etc. of that society. In the process of globalization, time and space as determining variables have been compressed to an extent that in certain areas, such as financial trading, an act could take effect instantaneously and regardless of where the initiator of that act is physically located. According to Scholte, global phenomena are not territorially fixed, distance is covered more or less instantaneously, and boundaries present no particular obstacle to interaction.[8] Consequently, the supraterritoriality, compression of space and time, and transborder characteristics of the flows in the present financial system make it both relevant and justifiable to talk about 'global' finance.

Globalization as supraterritoriality does not mean the end of geography or that territory has lost importance. According to Benjamin Cohen, increased financial globalization has diminished the importance of place in determining who uses what financial instrument, when, and for what purpose.[9] This means that geography is freed from its dependence on physical location and hence supraterritorialized. By definition, nothing can be supraterritorial without territorial dimensions. Therefore it is preferable to call this phenomena supraterritorialization rather than, for example, deterritorialization. The implication is that the importance of territory has changed and become more complex. There is an ongoing dialectical process where territorially bound events and supraterritorial events interact and transform social relations. It is this dialectical process and the impact of a rising number of supraterritorial phenomena that have transformed the world economy and world politics. Thus, one important approach to the study of globalization as supraterritorialization is the analysis of the structural impact of time-space compression on territorially bound units, such as the state. The impact of supraterritorial phenomena both constrains and enables social relations ranging from the individual to the global.

The impact and importance of time-space compression differs between areas. In international trade, for example, goods still have to be shipped (i.e. distance matters) and go through customs procedures (i.e. time matters) and the same usually goes for services. Of course, there has been considerable time-space compression over the last century, but it pales in comparison to financial trade. In financial trading, an act commonly takes effect instantaneously and regardless of where the initiator of that act is physically located. A trader buys futures in London and sells bonds in New York, while picking up a sandwich in her local deli.

The financial area is arguably the area where it is most relevant to refer to globalization. Of course, financial globalization is only part of an overarching economic globalization. But, in comparison with trade and foreign direct invest-

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[8] Ibid., 46-50.
[9] Cohen, *The Geography of Money*, 21.

ment (FDI), finance has come the furthest in the globalization process. Both cross-border trade and FDI have grown faster than global economic output, but they pale in comparison to the growth in transborder financial flows. Lowered trade barriers have opened markets, and improved transportation technology has decreased the cost and improved the quality of transportation. FDI is still very much a phenomenon in industrialized countries. Finance, on the other hand, has been reaching further into underdeveloped countries around the world through international lending and attached conditions.

Finance has increased its importance as a shaper of the world economy and, thus, increasingly also influences world politics. According to Cerny,

> The financial economy calls the tune for the real economy, whether in terms of short-term financial flows, patterns of investment, the restructuring of industries and markets, or the contours of state economic intervention. …the transnationalization of finance has developed its own autonomous structural dynamic, a dynamic with regard to which international politics has yet to find a workable consensus on objectives or a feasible method of control. …the world order follows the financial order.[10]

The tremendous increase in and reach of financial flows since the mid-1970s has been brought about by the confluence of a number of processes that has transformed the working of the global financial system. The most important of these processes are the deregulation of financial markets, new financial instruments such as derivatives, and technological advances in communications. The effect of these processes is the emergence of a highly interconnected global financial system.

Gilpin provocatively calls the remarkable growth in flows "a financial revolution." It has linked national economies ever more closely together, increased the availability of capital in the world economy, and accelerated economic development. However, because of the short-term, volatile and speculative character of a large portion of these flows, this global finance has also "become the most vulnerable and unstable aspect of the global capitalist economy."[11] Overall, financial globalization is a fiercely debated topic where the perspectives stretch from that of global finance as the healthy and beneficial triumph of capitalism all the way to the view that the global financial system is out of control and has to be reigned in.

Global finance is not an altogether new phenomenon. Cross-border financial flows have, of course, existed for centuries, and the intensity and extensity

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[10] Philip G. Cerny, "The Political Economy of International Finance," in *Finance and World Politics: Markets, Regimes and States in the Post-Hegemonic Era*, ed. Philip G. Cerny (Aldershot: Edward Elgar, 1993), 18.

[11] Robert Gilpin, *The Challenge of Global Capitalism: The World Economy in the 21st Century* (Princeton, NJ: Princeton University Press, 2000), 22.

of these flows have waxed and waned over time. There has been a lot of debate regarding the distinctiveness of the present surge in global finance, whether it is just a return to a previously experienced situation or something new. The perspective brought to the fore here is that there are decisive qualitative differences that constitute the break in the historical pattern of global finance and make the present surge in global finance stand out in comparison to previous eras of increasing cross-border financial flows. This qualitative difference can be found along a number of important dimensions. As Held *et al.* point out:

> The global financial system today embraces virtually every nation-state and economy, while the magnitude of gross financial flows is unprecedented, as is the shift towards almost instantaneous, real-time, around the clock, global financial trading. Furthermore, the enormous diversity of financial products traded and the complexity of new financial instruments reflect a fundamental shift toward an autonomous global financial market in which financial activity is largely divorced from the requirements of trade, that is, the exchange of goods and services.[12]

The qualitative shift experienced in the current surge of global finance does not necessarily mean that the surge is irreversible. The greater financial openness and enmeshment of the present financial system just mean it would take more effort to reverse the trend. Despite the fact that global finance now extends further around the planet than ever before and at much higher intensity, there are still social relations and institutions behind these flows that could shift their priorities with regard to international capital mobility. The likelihood of such a shift, however, is a different matter, as power relations on both international and national levels come into the equation.

As Helleiner points out, the problems of collective action are opposite in trade and finance. In trade, collective action problems appear when keeping the trading system open, and in finance, they arise when keeping the financial system controlled. For example, a hegemonic US might experience free-riding by other states (i.e. the US carries the burden of upholding and enforcing the rules of the system while other states take full advantage of the system) when trying to maintain an open trading system. In an open financial system, the opposite situation appears. The US could impose an open financial system and take full advantage of it, while states unwilling to deregulate would have to carry the cost of keeping their economies regulated. Consequently, it is more difficult to keep the system closed in finance than in trade, and openness is likely to be the normal condition in global finance.[13] This is also a reason for the increasing global reach of finance. It has been very difficult for countries to withstand the

[12] Held and others, *Global Transformations*, 221.
[13] Helleiner, *States and the Reemergence of Global Finance*, 196-8.

wave of deregulation after deregulatory measures were implemented in the US and the UK, and thus others decided to follow their lead.

Financial openness

The abolition of capital controls has been a major ingredient in the process of globalization and the rise of global finance. Capital controls have embraced a large set of measures or restrictions. Although the diversification of applied restrictions is high, their common goal has been to restrain non-governmental cross-border investment decisions.[14]

In the aftermath of the Second World War, policymakers believed that the best way to heal their war-torn economies was to impose various forms of internal and external regulations on the financial markets.[15] Capital controls were encouraged and the purpose was to create cheap domestic financing to boost domestic economic recovery. The imposition of external controls made it possible to introduce internal controls such as reserve requirements and interest rate ceilings, which paved the way for low-priced financing.[16]

It has been common practice to direct capital controls towards capital outflows in order to preserve scarce domestic savings for domestic use and reduce the risk of capital flight during periods of exchange rate pressure or balance-of-payment weakness. Restrictions on capital inflow from abroad have been imposed mainly for reasons of monetary control, or for non-economic reasons such as limiting or prohibiting foreign acquisition of domestic businesses or investment in real estate. Capital movements relating to individuals have been among the most restricted areas and also the last to be liberalized. Commercial credits and loans, on the other hand, have had a fairly high level of freedom since governments have believed restriction would unduly harm normal business relations.[17]

The primary rationale for capital controls is that they, if efficiently applied, provide governments with some level of freedom in national policymaking. The government could, for example, influence the level of inflation, interest rates, and exchange rates. If the government manages these variables, it could also improve the relative attractiveness of the country for international investors. Depending on the preferred variables, policymakers can choose an appropriate policy regime. There are three optional monetary regimes and these are based on three policy elements that can only be combined in pairs. Cohen calls this

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[14] Lars Oxelheim, *Financial Markets in Transition: Globalization, Investment and Economic Growth* (London: International Thomson Business Press, 1996), 10.
[15] Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System* (Ithaca, NY: Cornell University Press, 1996), 94.
[16] Helleiner, *States and the Reemergence of Global Finance*, ch. 2; Oxelheim, *Financial Markets in Transition*, 45.
[17] Oxelheim, *Financial Markets in Transition*, 45-6.

dilemma the unholy trinity.[18] The elements are fixed exchange rates, perfect capital mobility and national monetary autonomy. One regime combines a fixed exchange rate, capital controls, and national monetary autonomy. The second regime combines a fixed exchange rate, perfect capital mobility, and no national monetary autonomy. The third regime is based on floating exchange rates, perfect capital mobility, and national monetary autonomy. The incompatibility of currency stability, capital mobility, and national policy autonomy has mired the choices of policymakers for a long time.[19]

Facing this policy dilemma, many small open economies strove for a fixed exchange arrangement and generally prioritized monetary autonomy. This combination demanded a reduction in capital mobility by imposing capital and exchange regulations. After the abolition of capital controls in many countries over the last couple of decades, many small open economies have chosen or been forced to abandon a fixed exchange rate regime and instead have a floating exchange rate to preserve some monetary autonomy.[20]

The deregulation of the financial system has been a topic of discussion for a long time. Opinion began to turn in favor of relaxed controls on cross-border capital transactions in the 1950s. A manifestation of this came in the early 1960s with the adoption of the OECD's Code of Liberalization of Capital Movements. Still, international deregulation remained modest until the 1970s. In the 1980s deregulation gained momentum and in the 1990s it neared completion.

When governments have decided to proceed with the opening up of their financial system, they have in, general terms, followed one of three approaches to deregulation. They have pursued a longer-term and a shorter-term gradual approach, and the big bang approach. With regard to foreign exchange markets, the longer-term gradual approach is probably best represented by the deregulation that started in the 1970s in Denmark and Japan and was not completed until 15 years later. Sweden followed the somewhat oxymoronic shorter-term gradual approach when it deregulated foreign exchange markets during a relatively short period of five years from 1985 to 1989. The big bang approach is perhaps best represented by the UK in 1979, when that government abolished their forty-year old system of capital controls.[21] Regardless of the approach, the result on a global level is a degree of freedom unparalleled since the 1920s.

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[18] Benjamin J. Cohen, "The Triad and the Unholy Trinity: Lessons for the Pacific Region," in *Pacific Economic Relations in the 1990s: Cooperation or Conflict?*, ed. Richard Higgott, Richard Leaver, and John Ravenhill (Boulder, CO: Lynne Rienner Publishers, 1993).

[19] Cohen, *The Geography of Money*, 56.

[20] Oxelheim, *Financial Markets in Transition*, 11.

[21] Christina Telasuo, "Småstater under internationalisering: Valutamarknadens avreglering i Sverige och Finland på 1980-talet: En studie i institutionell omvandling [Small States under Internationalisation: Deregulation of the Foreign Exchange Markets in Sweden and Finland during the 1980's: A Study of Institutional Change]" (PhD Diss., Department of Economic History, Göteborg University, 2000), 19-20.

There are many contributing events and changes that have brought about the financial liberalization we see today. Depending on the level of detail and historical perspective, different weights are given to different factors. However, there are three events – the emergence of the Eurocurrency market, the collapse of the Bretton Woods system, and the oil price shock – that are hard to overlook in tracing the deregulation and opening of the financial system. These events are vital breaking points in the long-term unraveling of the old order, paving the way for the unrelenting expansion of financial flows in the 1980 and 1990s.[22] Intertwined with an ideological shift favoring deregulation of financial markets and technological changes, these events ushered in both extended and intensified global financial flows and networks further around the globe.

The growth of private international finance took off in the 1960s with the establishment of the Eurocurrency market. In this market, European banks began holding deposits in primarily American dollars, but also in other currencies. The deposits remained outside the domestic monetary system and scrutiny of national monetary authorities.[23] This new market offered investors an advantage over domestic banks. It became possible for investors to surpass national capital controls and many of the national regulations governing domestic banks. Instead of repatriating earnings from abroad and subjecting them to capital controls, multinational companies chose to deposit their money in the Eurocurrency market. The liquidity of the market and its rapid growth opened up the possibility of raising large loans. The Eurobond market evolved, in which borrowers issued bonds in foreign denominations, often outside their home jurisdiction. In providing mobile financial traders with a location where they could operate without regulation and supporting the growth of the Eurocurrency market, the US and the UK could unilaterally undermine the financial order through facilitating and augmenting the pressures for liberalization and deregulation.[24]

With the growth of the Eurocurrency market and the subsequent deregulation of the financial systems in the US and UK, a process of competitive deregulation started. In the 1970s and 1980s, foreign financial centers saw a migration of business and capital to these more attractive markets as the offshore financial market boomed and new tax havens opened up for business.[25] Keeping

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22 For detailed accounts of the Eurocurrency market and Bretton Woods system, see, for example, Eichengreen, *Globalizing Capital;* Helleiner, *States and the Reemergence of Global Finance;* Geoffrey R. D. Underhill, "The Making of the European Financial Area: Global Market Integration and the EU Single Market for Financial Services," in *The New World Order in International Finance*, ed. Geoffrey R. D. Underhill (Basingstoke: Macmillan, 1997), 102-5.

23 Robert Gilpin, *The Political Economy of International Relations* (Princeton, NJ: Princeton University Press, 1987), 314-5.

24 Helleiner, *States and the Reemergence of Global Finance*, 12.

25 Mark P. Hampton and Jason P. Abbott, "The Rise (and Fall?) of Offshore Finance in the Global Economy: Editors' Introduction," in *Offshore Finance Centres and Tax Havens: The Rise*

a level playing field through deregulation became crucial in balancing the flows in and out of the national economies. Thus, other advanced industrial states had much to lose if they were unwilling to follow the American and British lead and refused to deregulate their markets. Competitive deregulation came to be an important driver of financial liberalization in the advanced industrial world in the 1980s.[26]

The Bretton Woods system came under increasing pressure both because of the development of the Eurocurrency market and the diminishing international confidence in the sustainable value of the US dollar. This brought a wave of speculation against the US dollar and in 1971 President Nixon announced the cancellation of free convertibility of the dollar into gold, which effectively ended the fixed exchange rate regime. With this an era of floating exchange rates began, in which currencies were valued in a global market place according to supply and demand. The US took the position that the freedom of capital movements and freedom of trade in goods and services should be treated as equally important in a liberal economic system. This was an explicit challenge to the Bretton Woods system. The shift in approach to capital movements in the US reflected the increasing influence of neo-liberal thought in American politics. The US abolished its capital controls in 1974.[27]

After a failed attempt to resuscitate the Bretton Woods system, its collapse was complete in 1973 when OPEC quadrupled the price of oil, causing a huge transfer of funds from oil-importers to oil-exporters. The oil-exporters could not spend all their additional revenue and invested heavily in international money markets. This, of course, increased the liquidity of international banks to recycle through the world economy. With slowing growth in OECD countries, the banks had to search wider for lenders and found an insatiable demand in developing countries.[28]

The deregulation and abolition of capital controls has been a prerequisite for the rise of global finance and has both extended and intensified the global reach and impact of financial flows around the world. The wave of liberalization in the 1980s showed some important and related traits. First, the major actors in cross-border capital flows changed. Commercial banks pulled back from international lending after being overexposed in the developing world in the 1970s and early 1980s. New actors emerged and took over the channeling of cross-border flows of capital. Most important among these were investment banks, mutual funds, pension funds, and hedge funds. Second, the type of capital raised changed. The role of banks and conventional lending in raising capital diminished and instead securitization (the transfer of capital via the sale of

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of Global Capital, ed. Mark P. Hampton and Jason P. Abbott (Basingstoke: Macmillan Press, 1999), 3-5.

[26] Helleiner, *States and the Reemergence of Global Finance*, 12.

[27] Ibid., 106, 111, 115.

[28] Held and others, *Global Transformations*, 202.

stocks and bonds) became the most important way of raising and transferring capital. While in 1976-80 loans accounted for US$59.4 billion of lending in international capital markets, and securities accounted for US$36.2 billion, the reverse was true in 1993 when securities accounted for US$521.7 billion and loans for US$136.7 billion.[29] Third, there has been an explosion of financial activities and instruments such as arbitrage and derivatives. Fourth, the tremendous growth of over-the-counter (OTC) trading has made monitoring increasingly difficult. On OTC markets, traders buy and sell financial instruments directly over the phone or through electronic communications, without the mediation of an exchange. This is part of the general trend of disintermediation in financial markets.[30] Monitoring has also become more difficult because many of the transactions, such as forward contracts, were "off-balance sheet", i.e. were not reflected in the assets and liabilities statement. This makes the assessment of the actual financial condition of many institutions more complicated and uncertain.[31]

Financial openness has come a long way over the last couple of decades. However, as anyone who has tried to wire money or open a bank account abroad can account for, there are still various restrictions on cross-border capital flows in place today. There is still friction in the global financial system.

Financial enmeshment

The deregulation of financial markets has been a prerequisite for the growth of global finance, but to get some understanding of the extent of this growth it is now necessary to turn to the flows and the enmeshment of countries in global finance. On an aggregate world economy level it is difficult to find comprehensive measures of the growth of global finance. This is probably a function of the difficulty of gathering statistics in an increasingly complex financial system. This section will therefore present approximations with regard to the cross-border flows and volumes with regard to foreign exchange markets, international banking, international bonds and equity, and new financial instruments such as derivatives. Where possible FDI will be excluded, since these flows are of a long-term character and aim to gain influence or control over productive assets abroad. This type of investment does not fit the definition of global finance outlined in the introduction.

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[29] Paul Hirst and Grahame Thompson, *Globalization in Question* (Cambridge: Polity Press, 1996), 40.

[30] For a discussion on the intertwining of the processes of disintermediation and securitization, see Philip G. Cerny, "The Deregulation and Re-Regulation of Financial Markets in a More Open World," in *Finance and World Politics: Markets, Regimes and States in the Post-Hegemonic Era*, ed. Philip G. Cerny (Aldershot: Edward Elgar, 1993), 62-3.

[31] Walden Bello and others, "Notes on the Ascendancy and Regulation of Speculative Capital," in *Global Finance: New Thinking on Regulating Speculative Capital Markets*, ed. Walden Bello, Nicola Bullard, and Kamal Malhotra (London: Zed Books, 2000), 4.

Even if there is no comprehensive measure of gross financial flows in the world, there is little doubt that the flows have grown remarkably over the past decades. According to Herring and Litan, one plausible although imperfect approximation of the volume of international financial transactions is the value of payments cleared through CHIPS (the Clearing House Interbank Payment System).[32] CHIPS is an electronic payment system transferring and settling international transactions denominated in US dollars and handles 95 percent of all US dollar payments moving within the US economy and among countries worldwide. In 2002, the system transferred an average of US$1.26 trillion/day, up from US$147.8 billion/day in 1980.[33] Another similar approximation of the growth of financial flows is the operation of SWIFT (the Society for Worldwide Interbank Financial Telecommunications). SWIFT connects close to 7500 institutions in 198 countries and they estimate the average daily value of payment messages at more than US$5 trillion. The total number of messages has almost doubled since 1998 and reached over 1.8 billion messages in 2002. In the same time, SWIFT has added close to 1000 new members and another 20 countries to its network. [34] Thus, SWIFT connects members in more countries than the United Nations (The UN had 191 member states in 2002).

a. Foreign exchange markets

Foreign exchange markets are by far the largest international market of any sort.[35] The massive volume of transactions and the intense turnover rate make data collection difficult, but it is still easy to discern the spectacular growth over the last couple of decades. According to Gilpin, the volume of foreign exchange trading in the late 1990s reached approximately US$1.5 trillion per day, which is an eightfold increase since 1986. At the same time, the global volume of exports for all of 1997 was US$6.6 trillion a year, or US$25 billion a working day. [36]

The growth of speculative activity in these markets is at least in part a result of the breakdown of the Bretton Woods system. The fixed value of a currency, as previously in relation to gold under the gold standard and to the dollar in the Bretton Woods system, did not invite speculation as long as the confidence in the system remained and strict capital controls were upheld. In the present floating exchange rate system, however, the value of the currencies in the system is determined by around-the-clock trading in the foreign exchange centers of the world, primarily London, New York and Tokyo.

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[32] Richard J. Herring and Robert E. Litan, *Financial Regulation in the Global Economy* (Washington, DC: The Brookings Institution, 1995), 23.
[33] CHIPS, *CHIPS Annual Statistics from 1970 to 2003* [Internet] (CHIPS, March 2003, accessed May 2 2002); available from http://www.chips.org/stats.htm.
[34] SWIFT, *Annual Report 2002* [Internet] (2003, accessed May 2 2003); available from http://www.swift.com/temp/41604/43080/ar_2k2_full_b&w.pdf.
[35] Held and others, *Global Transformations*, 208.
[36] Gilpin, *The Challenge of Global Capitalism*, 22.

Exchange rates are now determined by the global demand and supply of a currency. However, it is still common that national authorities intervene in the foreign exchange market in an attempt to manage the exchange rate and keep it within a target range of certain currencies. It is also common practice for businesses to hedge themselves against sudden exchange rate movements. This has also increased opportunities for market actors to speculate on such movements. The removal of capital controls in OECD countries in the 1980s and 1990s, of course, also removed the official restriction on speculative activities.[37] In the 1990s, it also became commonplace that speculators at times took positions against fixed or managed exchange rates, betting that governments would be forced to devalue. The British pound, the Italian lira, and the Swedish krona are examples of currencies that caved in to the mounting pressure exerted by speculators in the numerous devaluation crises of the 1990s.

b. International banking - loans and deposits

The rapid development of international banking is another example of the rise of global finance. Since the 1960s there has been a substantial shift in the focus of the banking sector. International banking has moved from being a sideshow of domestic banking to becoming an integral part of the banking industry. According to UNCTAD, the gross size of the international banking market has grown as a percentage of world output from 1.2 percent in 1964 to 37 percent in 1991.[38] The rise of international banking, of course, only captures part of the rise of global finance. Nevertheless, this growth provides perspective regarding the remarkable change the world economy has gone through over the last couple of decades.

International bank lending encompasses banks lending abroad in both their national currency and in foreign currencies. Directly after the oil shock in 1973 the proportion of loans going to non-OECD countries increased rapidly from a low level of about 5 percent to a range of a quarter and a third of the loan total. In the latter part of 1980s this proportion had diminished again so that the brunt of international bank lending stayed within the OECD countries. This return to the earlier pattern of financing in the developing countries was partly a consequence of a decline in loans and partly that developing countries had found other ways to raise capital.[39]

Apart from lending, international banks also handle deposits. It has been increasingly easy to deposit savings globally in the last few decades. The world

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[37] Held and others, *Global Transformations*, 209.

[38] UNCTAD, *World Investment Report 1994: Transnational Corporation, Employment, and the Workplace* (New York, NY: United Nations, 1994), 128.

[39] Eichengreen and Fishlow call these different approaches in raising capital the era of bank finance and the era of equity finance respectively. See Barry Eichengreen and Albert Fishlow, "Contending with Capital Flows: What is Different about the 1990s?," in *Capital flows and financial crises*, ed. Miles Kahler (Ithaca, NY: Cornell University Press, 1998).

total of bank deposits owned by non-residents rose from US$20 billion in 1964 to US$7.9 trillion in 1995. In 1990 around 40 percent of the deposits in commercial banks in the world's financial centers came from non-residents. Today, savers can use transworld bank networks to place funds anywhere in the world. Several trillion dollars are, for example, deposited in offshore finance centers.[40]

c. International bonds

Not only international bank lending has grown rapidly since the 1960s; the issuing of international bonds has also grown remarkably. International bonds started to exceed the flow of bank loans in 1983 and since then they have dominated new bank lending. There has been continuous development of bond characteristics and they have become more and more related to equity. [41] Issuing international bonds is a cheap and effective way of raising capital and consequently its share of world capital markets has increased. Governments, corporations and financial institutions issue bonds, the vast majority of which are issued in developed countries. A large part of government debt is financed through the issuing of international bonds and consequently foreign holdings of debt have grown too. Total outstanding debt securities are valued at about US$30 trillion, whereof 85 percent is held domestically and 15 percent internationally.[42]

d. International equities

Cross-border flows of equities have also become more important in recent decades. The stock market has grown decisively – the market value of all listed shares across the world rose from US$9.4 trillion in 1990 to US$20.2 trillion in 1997. At the same time, trading activity grew sharply, reaching a value of US$15 trillion per year. About a billion people are believed to invest directly or indirectly in the stock markets of the world.[43]

Although foreign issuing of equities has grown, it still makes up only a minority of stock market activity. The major growth has taken place in cross-border equity flows. These flows arise when investors in one country buy shares on foreign stock exchanges. These shares are usually only issued on the local stock market but are held by foreign investors. According to the IMF, gross cross-border equity flows have jumped from over US$1 trillion in 1980 to around US$2.5 trillion in the mid-1990s and the net flows have gone from

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[40] Scholte, *Globalization*, 79.
[41] Herring and Litan, *Financial Regulation in the Global Economy*, 27-8.
[42] Understanding Global Issues, *Money Across Frontiers: The Explosion of Global Finance* (Cheltenham: Understanding Global Issues Limited, 1999), 3, 99/3.
[43] Ibid., 3,6.

US$32.9 billion in 1988 to US$119.6 billion in 1994.[44] The net flows are decisively smaller than the gross flows because the differences in returns between countries tend to be small and only of temporary nature. The high activity is driven by investors seeking to diversify their portfolios internationally. Pension funds and insurance companies have sought to do this, in particular.

e. New financial instruments

The most dramatic growth in international financial transactions has been in new financial instruments. The development of new instruments has been so fast that it has become increasingly difficult for non-specialists to separate and understand them. At the same time, they have been an important addition to the arsenal of risk managers all over the world. New terms such as derivatives, futures, swaps and options have entered the vocabulary of anyone with the slightest interest in the business pages of a newspaper. These new financial instruments have grown astronomically over the last few of years. The estimated outstanding amount of exchange-traded derivatives has gone from US$729.9 billion in 1987 to US$14.3 trillion in 2000. In the same period, the annual turnover rate has gone from 389.6 million traded contracts to 1,642.4 million traded contracts.[45] For a sense of the aggregate turnover on exchange-traded derivatives, the value of transactions monitored by the BIS increased in 2001 by 54% to US$594 trillion.[46] With the increasing number of cross-border transactions a global market for derivatives is continuously evolving.

The growth of international capital flows in the 1990s has been dramatic. The assets managed by institutional investors located in mature, as opposed to emerging, markets more than doubled to over US$30 trillion, which is about equal to world GDP. [47] The impact of these already enormous investments is deepened by the fact that they are leveraged, i.e. made with borrowed funds. Derivatives, securities, and other financial assets valued at US$360 trillion have of course also contributed to the impact, complexity and potential instability of global finance.[48] As a consequence of the widespread capital account liberalization and increased reliance on securities markets, investable funds have become increasingly responsive to changing opportunities and risks in a widening set of countries and regions. The sheer size of global investment portfolios has made it possible for proportionally small portfolio adjustments to cause large and volatile swings in capital flows. According to the IMF, these adjustments could

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[44] IMF, *International Capital Markets: Developments, Prospects and Policy Issues* (Washington, DC: International Monetary Fund, 1995), 189-90.

[45] IMF, *International Capital Markets: Developments, Prospects and Key Policy Issues* (Washington, DC: International Monetary Fund, 2001), 22-3.

[46] Bank for International Settlements, *BIS Quarterly Review, March 2002: International Banking and Financial Market Developments* (Basle: Bank for International Settlements, 2002), 32.

[47] IMF, *International Capital Markets 2001*, 4.

[48] Gilpin, *The Challenge of Global Capitalism*, 6.

have a significant impact on the financial situation in the recipient country, by triggering both capital inflows and outflows. This underscores the powerful impact of portfolio rebalancing on the volume, pricing and direction of capital flows and on the conditions in both domestic and international markets.[49]

Qualitative and quantitative changes in global finance

This section has touched upon many of the qualitative and quantitative changes in the working of the financial system over the last few decades. With the contemporary rise of global finance, there is now nearly universal participation among countries in the international financial and monetary order even if the level of participation differs significantly between them. An unprecedented volume of gross capital flows across borders and these flows are more diversified than ever. At the same time, the speed of capital flows has increased to an extent that capital shifts happen more or less instantly and around the clock due primarily to improved information and communications technology.

Furthermore, finance has reached unprecedented levels of commodification in the sense that financial instruments are traded in a circuit of accumulation in which the relation to production is limited or absent. Foreign exchange, for example, can be bought and sold to enable cross-border trade, or simply to make a profit in its own right. The relationship between financial instruments and tangible resources has diminished in recent decades. In 1970, about 90 percent of transactions in foreign exchange markets were related to trade in 'real' goods and services; in the early 1990s only five percent were.[50] By the late 1990s, the proportion had diminished further to less than 2 percent.[51] The increasing value of portfolio investment in comparison to FDI is another example of commodification. In 1970, portfolio investment and FDI were roughly equal, but in the 1990s portfolio investments were three times as large as FDI. The innovation and rapid proliferation of new financial instruments also suggest a commodification of finance.[52] The commodification that has followed the contemporary rise of global finance has shifted the relative weight of accumulation in the world economy from the tangible (merchandise) toward the intangible (finance and information). The 'real' economy is clearly not as dominant as it used to be. This is part of the shifting structure of the world economy. The nature of reality has changed.

In all, the global financial system has seen tremendous changes both in terms of financial openness and financial enmeshment over the last few decades. Many countries have gone through far-reaching deregulation of their financial markets and capital controls and this has been a necessary condition for

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[49] IMF, *International Capital Markets 2001*, 4.
[50] Scholte, *Globalization*, 116.
[51] Gilpin, *The Challenge of Global Capitalism*, 6.
[52] Scholte, *Globalization*, 116-7.

the qualitative and quantitative transformation of global finance. This transformation has also meant that the enmeshment of countries in global finance has reached unprecedented levels. The dependence on and stakes in an efficient and stable financial system have never been higher.

3.3. Sweden and the rise of global finance

This section will concentrate on the Swedish experience of the rise of global finance. First, this section focuses on the regulatory changes that opened up the financial markets to cross-border flows, and then on the development of capital flows and the financial enmeshment of Sweden in the global financial system.

Swedish financial openness

The financial history of Sweden over the last century could be described as comprising three phases when it comes to the scope of the financial market, openness, and regulation. The first phase started with the gold standard in the 1870s and ended with the regulation of trade and financial flows in the 1930s. Free movement of capital and labor across borders, rapidly growing financial systems, and limited state intervention in the economy characterized this period. The second phase grew out of the great depression in the 1930s and World War II. Far-reaching regulation constrained financial markets and this system became institutionalized in the Bretton Woods system. In order to create and maintain national economic and political independence, cross-border financial flows were limited. The regulation of the Swedish financial system took place at this time and interest rates and credit flows were driven by political priorities rather than market decisions. The third phase began with the breakdown of the Bretton Woods system in the early 1970s. In the 1980s, Sweden began the deregulation of its financial system – a change that contributed to considerable economic and political turbulence in the late 1980 and early 1990s. According to Swank, Swedish and other Scandinavian capital markets were significantly less integrated with world markets than other advanced market economies until the mid-1980s, but it only took until the late 1980s for Scandinavian capital markets to reach a level of capital market integration that they closely resembled other advanced market economies.[53] The financial deregulation of the Swedish economy has now come far enough that it can be claimed that Sweden is financially open to the rest of the world. The Swedish economist Lars Jonung even goes so far as to claim that Sweden is back in a situation that from a regulatory and institutional standpoint more resembles the era of the gold standard than the

[53] Duane Swank, "Social Democratic Welfare States in a Global Economy: Scandinavia in Comparative Perspective," in *Globalization, Europeanization and the End of Scandinavian Social Democracy?*, ed. Robert Geyer, Christine Ingebritsen, and Jonathon W. Moses (Basingstoke: Macmillan Press, 2000), 99-100.

framework in place from 1939-89, when the Swedish economy was more or less disconnected from international capital flows.[54]

Oxelheim has calculated a financial external openness index based on the sum of non-government gross capital account (residential and non-residential) transactions as a percentage of GDP. The index shows both that Swedish financial openness has increased sharply over the last few decades and that the increase in openness stands out in a Nordic comparison.

Table 1. Financial External Openness in the Nordic Countries (index 1970 = 100)[55]

	1950	1960	1970	1980	1990
Sweden	8	36	100	276	2532
Norway	-	90*	100	177	867
Finland	-	39	100	94	209
Denmark	-	23	100	312	1350

* Openess in 1965

The financial deregulation and liberalization program in Sweden came as a dramatic shift from previous policies. Both internal and external controls on finance had been a central element of post-war planning strategies. The widening budget deficits and growing public debt in the 1970s made the obligations on banks to buy government and housing bonds increasingly distortionary, because a growing share of deposits were transferred to the government in exchange for long-term bonds bearing low interest. This resulted in a declining share of regular bank loans to households and businesses, and in the growing significance of institutions that were not covered by regulations. The growing credit flows outside the regulated market challenged the traditional position of banks. The banks responded with an attempt to circumvent the interest rate regulations by establishing their own finance companies. These companies formed an important part of the informal credit market in Sweden. The increased inefficiency of financial intermediation, the globalization of financial markets, and the perception that regulations increasingly were being circum-

[54] Lars Jonung, "Den finansiella marknaden och demokratin i Sverige [The Financial Market and Democracy in Sweden]," in *Globaliseringen och demokratin - dokumentation från ett seminarium, SOU 1999: 56 [Globalization and democracy - documentation from a seminar, Swedish Official Governmental Reports 1999:56]*, Demokratiutredning skrift nr. 22, SOU 1999:56 (Stockholm: Fakta Info Direkt, 1999), 59; Jonung, "Den finansiella revolutionen," 40.
[55] Oxelheim, *Financial Markets in Transition*, 64.

vented led the Swedish authorities to initiate financial liberalization in the late 1970s and carry it through in the 1980s.[56]

The Swedish model came under increasing pressure in the 1980s. The pillars of this model were the governmental direction of both capital and labor markets to achieve high growth rates and the redistribution of income through taxation, a taxation that also financed the expansion of public services. The decisive blow to this model came with the 16 percent devaluation of the Swedish currency in the fall of 1982, just after the newly elected Social Democratic government took over the government. This devaluation had immediate repercussions on Swedish debt policy and therefore also on the credit market. The interest paid on foreign debt increased. At the same time, the liquidity in the corporate sector increased through circulation on markets beyond the controls exerted on the domestic credit market. The rapid internationalization of business had opened up new channels for credit and further reduced the efficiency of domestic controls. This changed the loan situation for the government. The new credit market could not be regulated with interest ceilings. The government had to issue competitive treasury bills and other instruments to attract money to finance balance-of-payment and budget deficits. At the same time the government had to scale back the regulation of the institutionalized domestic credit market and liberalize the banking sector.[57] It was difficult for a relatively small open economy with a fixed exchange rate like Sweden's to lower the interest rate to encourage domestic investment. In the early 1980s, policymakers in Sweden began to realize that it had become almost impossible to control overall credit availability. Consequently they were pushed into the deregulation process in order to avoid the increasing costs and inefficiencies stemming from the capital controls.[58]

The Swedish deregulation of the financial market is remarkable in that it took place without much debate of its consequences and implications.[59] The

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[56] Burkhard Drees and Ceyla Pazarbasioglu, *The Nordic Banking Crises: Pitfalls in Financial Liberalization?* (Washington, DC: International Monetary Fund, 1998), 9-10, Occasional Paper, 161.

[57] Lennart Schön, *En modern svensk ekonomisk historia: Tillväxt och omvandling under två sekler [A Modern Swedish Economic History: Growth and Restructuring during Two Centuries]* (Stockholm: SNS Förlag, 2000), 495.

[58] Oxelheim, *Financial Markets in Transition*, 398-9.

[59] See, for example, Ingvar Carlsson, *Så tänkte jag: Politik & dramatik [Thus I Thought: Politics and Drama]* (Stockholm: Hjalmarsson & Högberg Bokförlag, 2003), 211-20; Torsten Svensson, *Novemberrevolutionen: Om rationalitet och makt i beslutet att avreglera kreditmarknaden 1985 [The November Revolution: On Rationality and the Exercise of Power in the Process of the Deregulation of the Credit Market]*, Ds 1996:37 (Stockholm: Fritzes, 1996), 145-9. According to Carlsson, the economists at LO were among the few critics of the deregulation (p.221). They were concerned about the potential consequences of the deregulation. This internal division within the Social Democratic Party is part of the explanation for the problems of implementing tighter fiscal policies.

liberals and conservatives in opposition promoted deregulation, but it never became a major political issue. According to Jonung,

> The deregulation movement was initiated by the Ministry of Finance and the Riksbank; practically all of the deregulatory measures were decided with no or only minor political debate. They gave the impression of being 'technical' adjustments rather than viewed as fundamental changes in the policy regime.[60]

The silence surrounding the deregulation is still a contentious issue, especially within the Social Democratic Party. In his memoirs, Kjell-Olof Feldt, the Minister of Finance at the time, gives an account of how readily the Social Democrats dismantled one of its long-term pillars for controlling the Swedish economy and gave in to the neoliberal ideology professing deregulation of financial markets. In November 1985, when Kjell-Olof Feldt informed Olof Palme, the Prime Minister, about the Riksbank's proposal to take away the remaining regulations, his response was: "Do what you want. I don't understand anything anyway."[61]

Sweden deregulated its financial markets gradually. First, the domestic credit and bond markets were deregulated, followed by the removal of restrictions on international transactions. The system of liquidity ratios for banks was suddenly taken away in 1983. This was an important decision on the way to deregulating the financial market because it opened up a market for Treasury bonds. Then, the Riksbank lifted the interest rate regulations on commercial bank lending were in May 1985. However, it was the decision to lift the loan ceilings on November 21, 1985 that paved the way for the massive credit expansion in the Swedish economy.[62] Later this decision has been referred to as the "November revolution"[63] and Jonung calls it "the most far-reaching shift in the monetary policy strategy of the Riksbank since World War II."[64] One reason for the lack of debate is, according to Svensson, that the deregulation of the credit market was regarded as a change of one instrument in the Riksbank's credit

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[60] Lars Jonung, "The Rise and Fall of Credit Controls: The Case of Sweden, 1939-89," in *Monetary Regimes in Transition*, ed. Michael D. Bordo and Forrest Capie (Cambridge: Cambridge University Press, 1994), 365.

[61] Kjell-Olof Feldt, *Alla dessa dagar...: I regeringen 1982-1990 [All These Days...: In the Government 1982-1990]* (Stockholm: Norstedts Förlag, 1991), 260. My translation. For a criticism of Feldt, see Carlsson, *Så tänkte jag*, 214-8.

[62] Lars Wohlin, "Bankkrisens upprinnelse [The Origin of the Banking Crisis]," *Ekonomisk Debatt* 26, no. 1 (1998): 21.

[63] For a detailed study of the decision to deregulate the credit market, see Svensson, *Novemberrevolutionen*.

[64] Lars Jonung, "Riksbankens politik 1945-1990 [The Policy of the Riksbank 1945-1990]," in *Från räntereglering till inflationsnorm: Det finansiella systemet och riksbankens politik 1945-1990 [From interest regulation to inflation norm: The financial system and the policy of the Riksbank 1945-1990]*, ed. Lars Werin (Stockholm: SNS Förlag, 1993), 312. My translation.

policy arsenal and therefore it could take place without the usual scrutiny of the government and Parliament.[65]

After the deregulation of the domestic credit market, the focus moved towards liberalization of foreign exchange regulations. With a deregulated domestic credit market and an international trend of currency deregulation, the Swedish foreign exchange regulations seemed outdated. The government followed the recommendations from the Riksbank and Ministry of Finance, rather than majority (including the Social Democrats) on the split parliamentary Valutakommittén (Currency Committee) that recommended a reformed currency regulation.[66] Ingvar Carlsson, the Social Democratic Prime Minister at the time, explains the government's decision in his memoirs: "Also Sweden had to live according to the conditions now in effect internationally."[67] The deregulation of foreign exchange restrictions began in 1986 and no restrictions remained in 1990.[68] Foreign banks were allowed to establish subsidiaries in Sweden in 1986 and were granted permission to establish branch offices in 1990. The first foreign bank branch opened in 1992. Still, the foreign share of the total banking market has remained quite small. However, in 2001 approximately half of the credit granted by Swedish banks to the general public comprises foreign borrowers. This is primarily the result of bank mergers and acquisitions in the Nordic region, but is nonetheless an indicator of the increasing financial enmeshment in global finance.[69]

Before the external deregulation started, the foreign exchange controls in Sweden were based upon the Foreign Exchange Act of 1939 and applied by the Riksbank. In general terms, the Act had come about in an attempt to protect and support the Swedish economy in case of war and it prohibited capital transactions that resulted in outward and inward portfolio investments. For example, this ruled out the acquisition of foreign bonds and shares, and bank deposits in foreign currencies abroad. In practice, however, exceptions were made for foreign investors acquiring shares listed on the Swedish stock exchange. Moreover, outward and inward direct investments were allowed as long as they passed a test of "genuineness". Transactions related to trade including the financing of loans were exempted from controls, provided the normal trading conditions

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[65] Torsten Svensson, *Marknadsanpassningens politik: Den svenska modellens förändring 1980-2000 [The Marketization of the Swedish Model]* (Uppsala: Acta Universitatis Upsaliensis, 2001), 80.
[66] Valutakommittén, *SOU 1985:52 – Översyn av valutaregleringen: slutbetänkande [Overview of the Foreign Exchange Regulation: Final Opinion]* (Stockholm: Liber/Allmänna Förlaget, 1985). The report arrived on 8 November, 1985, less than two weeks before the so-called November revolution.
[67] Carlsson, *Så tänkte jag*, 223.
[68] Mats Larsson, *Staten och kapitalet: Det svenska finansiella systemet under 1900-talet [The State and Capital: The Swedish Financial System during the 1900s]* (Stockholm: SNS Förlag, 1998), 207.
[69] Sveriges Riksbank, *Financial Stability Report no. 2* (Stockholm, 2001), 31.

were adhered to. Incoming portfolio investments in Swedish kronor were prohibited, although in practice exceptions were made for the acquisition of shares listed on the stock exchange. Finally, incoming portfolio investments in foreign currencies in the form of Swedish borrowing abroad were subject to liberal regulations, which meant that the minimum term of the loan was two years.[70]

The purpose of foreign exchange controls in Sweden as a supplementary monetary policy has varied over the years. According to Oxelheim, their purpose was threefold during the 1970s and 1980s. First, the objective was to make the private sector help cover foreign borrowing needs while reducing the interest effects on the domestic credit market, and to stabilize the amount of private debt in foreign currency. Second, they sought to reduce the private capital movements that could have triggered random or systematic disturbances in the external value of the domestic currency. Third, the controls provided incentives to keep investment in the country. For example, a higher factor price in Sweden was supposedly advantageous to a foreign factor price plus the exchange uncertainty of a foreign investment.[71]

The distinction made in the OECD capital liberalization code between portfolio and direct investment has been important in shaping exchange controls in Sweden. Swedish exchange controls were aimed primarily at restricting crossborder transactions in shares, bonds and loans. Through the OECD capital liberalization code, Sweden obtained international sanction against this type of capital transaction.[72] Sweden undertook to adopt the code's fundamental principle that foreign direct investment should not be restricted by exchange policy or other controls. This made it necessary to monitor the genuineness of the direct investments, which was not always easy. The boundaries blurred both regarding intentions and the changing nature of investments over time. For example, an investment that might have started out as a direct investment could over the years effectively turn into a portfolio investment.[73]

The pacing of the deregulation differed between inward and outward portfolio investment. For outward portfolio investment, the shift was decisive and fast. For example, foreigners' loans in Swedish kronor had previously been very restricted, and it was free for Swedes to buy foreign bonds in conjunction with the removal of foreign exchange restrictions. Furthermore, one could buy unrestricted amounts of foreign shares, although the shares had to be deposited with a foreign resident bank or stockbroker. For inward portfolio investment, on the other hand, the shift was more gradual. Previously loans had been re-

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[70] Oxelheim, *Financial Markets in Transition*, 148.
[71] Ibid., 134. See also Clas Wihlborg, "Valutapolitiken [The Foreign Exchange Policy]," in *Från räntereglering till inflationsnorm: Det finansiella systemet och riksbankens politik 1945-1990 [From interest regulation to inflation norm: The financial system and the policy of the Riksbank 1945-1990]*, ed. Lars Werin (Stockholm: SNS Förlag, 1993), 251-8.
[72] Oxelheim, *Financial Markets in Transition*, 135.
[73] Ibid., 134-5.

stricted, but legal entities were allowed to borrow in foreign currency for maturities exceeding one year. The borrowing policy of 1974 had been aimed at stimulating Swedish companies to borrow abroad in order to help fund the current account deficits in the aftermath of the oil crisis.[74] Until 1977, the idea had been that the government should not borrow abroad. In the period 1977 to 1979 the government was allowed to borrow as long as the amount did not exceed the corresponding current account deficit. In 1984 the government decided that private foreign borrowing would finance a deficit in the current account, if such a deficit appeared.[75] In 1989 non-residents became free to buy non-listed shares on the stock exchange, whereas previously they had only been allowed to buy listed shares. It also became possible for foreigners to buy Swedish krona-denominated bonds.[76]

The deregulation process in Sweden was not combined with sufficient fiscal and monetary measures to counteract the expansionary impulse of the deregulation.[77] During the boom, the Social Democratic government realized the importance of tightening fiscal policies, but failed to convince the affiliated LO (Swedish Trade Union Confederation) of the need for measures. Rather, LO wanted the Riksbank to re-impose the credit regulation.[78] The conflict within the labour movement stymied pre-emptive action effectively and the boom continued. At the same time, the Riksbank aimed to maintain a fixed exchange rate and this made it impossible for the Riksbank to cool the Swedish economy by raising the interest rate. Sweden entered a boom-and-bust cycle. High inflation, increasing asset prices and low unemployment characterized the boom in 1986-1990. The boom turned into a deep recession around 1991. The deregulation of the financial markets was not the only factor leading to the spectacular financial crisis of 1992, but the decisions to deregulate first the domestic credit market in 1985 and then the foreign exchange controls in 1989 most certainly played a key role.[79]

From 1982 to 1991, the Social Democratic Party governed Sweden and the deregulation was part of an attempt to re-orient the party and Swedish society towards market solutions and less regulation. The focus was trimmed on the

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[74] Wihlborg, "Valutapolitiken [The Foreign Exchange Policy]," 283.
[75] Ibid., 284.
[76] Oxelheim, *Financial Markets in Transition*, 149.
[77] Similar problems occurred in Norway and Finland, while Denmark managed to counteract a severe banking crisis.
[78] Feldt, *Alla dessa dagar...: I regeringen 1982-1990 [All These Days...: In the Government 1982-1990]*, 394-9. According to Wohlin, the economists at LO rightly criticized the deregulation of the credit market, but they did not suggest an alternative deregulatory route and were therefore perceived as negative to any change of the financial system Wohlin, "Bankkrisens upprinnelse [The Origin of the Banking Crisis],": 29. See also Wihlborg, "Valutapolitiken [The Foreign Exchange Policy]," 271-2.
[79] Lars Jonung, *Looking Ahead through the Rear-View Mirror: Swedish Stabilisation Policy as a Learning Process, 1975-1995* (Stockholm: Fakta Info Direkt, 1999), 281, DS 1999:9.

Swedish context and domestic political problems, rather than what was happening in the global economy. As the party prepared itself for the 1990s, Kjell-Olof Feldt regrets in his memoirs, it "did not discuss the implications for the Swedish economy and society of the fundamental transformation induced by the internationalization of markets, businesses, and technology."[80] Thus, pro-active adaptation to the transformations in the global economy was not high on the political agenda. The outlook of the Swedish political elite would soon shift dramatically as the recession and financial crisis gathered pace.

At the peak of the crisis, the Riksbank suffered massive reserve losses in its staunch defense of the krona and interest rates peaked at 500 percent on September 16, 1992.[81] In all, Sweden spent an astonishing, but ultimately unsuccessful, US$3,500 for each resident of Sweden in the fight to defend the krona.[82] The krona's unilateral peg to the ECU (European Currency Unit) had to be abandoned and the krona began to float. This stubborn defence of the krona was a decisive and costly departure from the previous policy of devaluation as the panacea to lagging productivity and competitiveness. However, the high price paid sent a clear message of a policy shift to the financial markets. The actions during the defense of the currency and in the aftermath of the crisis established sufficient credibility to convince the financial markets that Swedish politicians had turned onto a norm-based neoliberal path, leaving the more pragmatic Swedish model behind. The crisis also meant that the public and politicians alike realized that the future prosperity of Sweden had to be negotiated with forces beyond the control of Swedish politicians. Their experiences of how the market forces took control of the state's financial destiny left them with a sense of vulnerability and powerlessness.[83]

When Social Democratic Prime Minister Ingvar Carlsson resigned in the spring of 1995, he portrayed the financial markets as a serious threat to Swedish independence and democracy. He went so far as to say "Sweden has never been more threatened as an independent nation since World War II, than when we

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[80] Feldt, *Alla dessa dagar...: I regeringen 1982-1990 [All These Days...: In the Government 1982-1990]*, 409.

[81] For detailed accounts of the crisis, see, for example, Hinnfors and Pierre, "The Politics of Currency Crises in Sweden,": 108-9; Lars Jonung, ed., *På jakt efter ett nytt ankare: Från fast kronkurs till inflationsmål [In Pursuit of a New Anchor: From a Fixed Krona to an Inflation Target]* (Stockholm: SNS Förlag, 2003); Lindgren, "Vad styr ledaren? Om beslutsfattare och policyförändring i säkerhetspolitiska kriser [What Guides the Leader? How Does the Leader Guide? On Decision-Makers and Policy Change in Security Policy Crises]"; Stern and Sundelius, "Sweden's Twin Monetary Crises of 1992,"; Teorell, "Demokrati eller fåtalsvälde?".

[82] Eichengreen, *Globalizing Capital*, 174.

[83] Anne Wibble, *Två cigg och en kopp kaffe [Two Cigarettes and a Cup of Coffee]* (Stockholm: Ekerlids Förlag, 1994), 39.

took over the government…. We faced not only an economic disaster, but also a disaster for Swedish democracy."[84]

Swedish financial enmeshment

This section will concentrate on the development of cross-border flows in and out of Sweden and the enmeshment of Sweden in the global financial system since the liberalization process started in 1985. The aim is to trace the growth of global finance in Sweden and analyze to what extent Sweden has been part of the general trends in global finance. The complexity of contemporary financial markets makes it difficult to give a comprehensive picture but this section will provide some approximations of the imprint of global finance on the financial markets in Sweden. The data comes mainly from the national accounts and to map the trends the focus will be primarily on cross-border stocks of financial assets and liabilities, but flows will also be discussed.

As pointed out above, technical innovations and growth in financial markets had already been diminishing the effect of currency controls for some time when the last prohibition against foreign investors' purchases of Swedish securities denominated in Swedish currency was lifted in 1989. Consequently, the deregulation did not have a sudden impact on the volume of the capital flows in 1989. Rather, the volume of capital flows has evolved over time.[85]

Cross-border financial flows are registered in the financial account part of balance of payment statistics. Cross-border financial flows, of course, vary a lot from year to year and especially so in a relatively small open economy dominated by large multinational corporations. Specific decisions by financial market actors can influence annual flows decisively and that makes it difficult to decide whether the changing flows are part of a trend or a deviation. However, the financial account shows a few clear trends in the magnitude of the flows in and out of Sweden. For example, the outflow of portfolio investment has gone from US$47 million in 1985 to about US$12.7 billion in 2000, while the inflow of portfolio investment has gone from US$609 million to about US$9 billion in the same period.[86] When the statistics for cross-border flows of financial derivatives appeared in 1995, the Swedish market for derivatives was already substantial. For example, the growth of the Swedish derivatives market was the fastest in the world between 1989 and 1993.[87] Both flows of financial derivative assets and

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84 Quoted in Jonung, "Den finansiella marknaden och demokratin i Sverige," 71.My translation.

85 Thomas Franzén and Kerstin Mitlid, "A Swedish Perspective," in *The European Currency Crisis: What Chance Now for a Single European Currency*, ed. Paul Temerton (Cambridge: Probus Publishing Company, 1993), 277.

86 Data collected from IMF, *Financial Statistics Yearbook 2001* (Washington, DC: International Monetary Fund, 2001), 948-53.

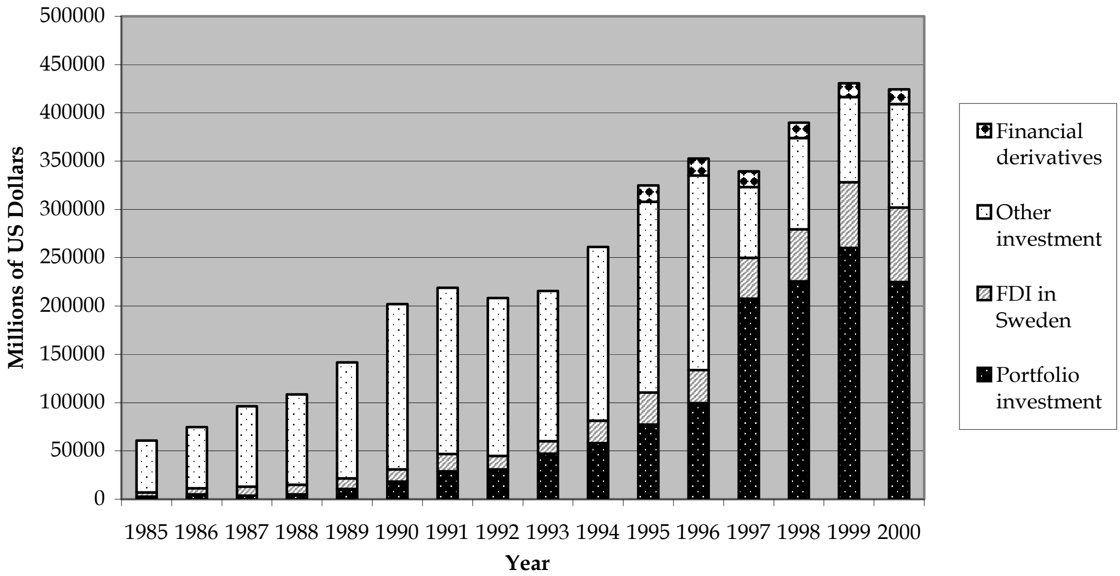
87 Johan Schück, "Riskhandeln i Sverige ökar mest i världen [Risk Trading in Sweden Increases Faster than Anywhere Else in the World]," *Dagens Nyheter*, 24 April 1995.

liabilities were valued at about US$20 billion each in 1995 and had grown to about US$30 billion each in 2000. The "Other Investment" component of the financial account, where transactions in currency, deposits, loans and trade credit are registered, also shows remarkable growth in flows. In 1985 the asset flows were valued at US$219 million and in 2000 at US$16 billion, while the liabilities flows reached a value of US$1.8 billion in 1985 and US$36.6 billion in 2000.[88]

The financial account shows that the annual flows in and out of Sweden have grown significantly in magnitude over the last fifteen years. Another way of describing this growth is through the Swedish international investment position, where the stock of external financial assets and liabilities are registered. The benefit of looking at stocks instead of flows is that the trend becomes clearer as the impact of extraordinary flows diminishes.

The Swedish international investment position has also changed remarkably over the last fifteen years. The growth of the investment stocks clearly shows the increasing Swedish enmeshment in and exposure to global financial markets. The Swedish development has followed the other OECD countries quite closely. For example, there has been much faster growth in portfolio investment than in FDI. The relative weight of the category "Other Investment" has diminished and financial derivatives have, although the stocks are still quite small, made a rapid impact in capital flows.

Figure 1: Swedish international investment position (stock of liabilities), 1985-2000.[89]



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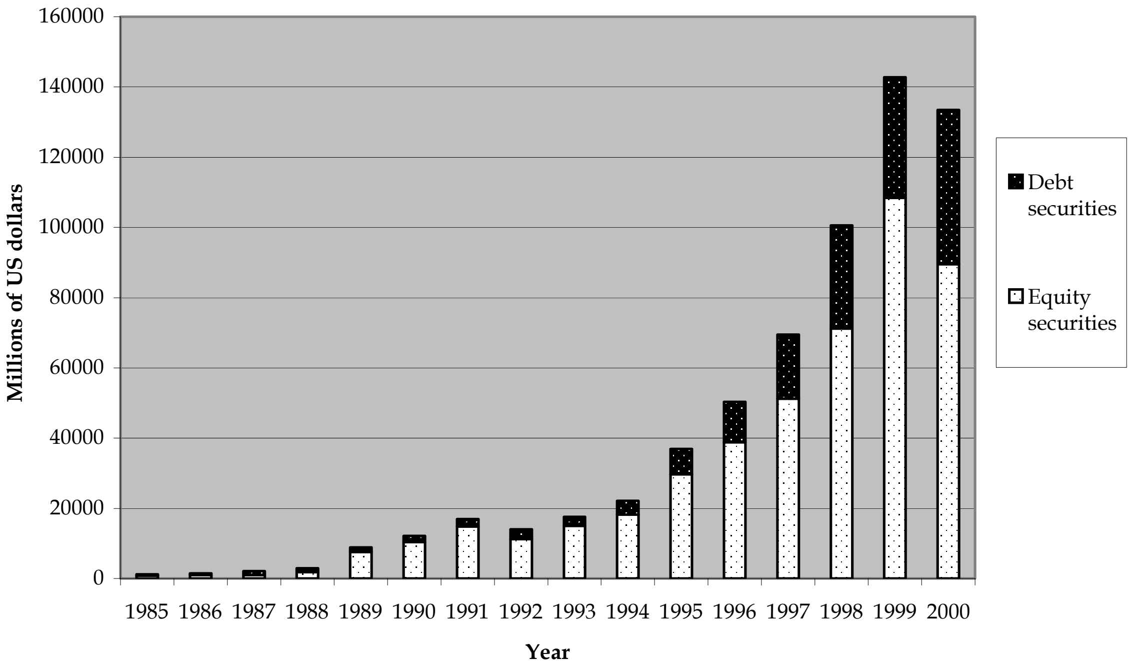
[88] Data collected from IMF, *Yearbook 2001*, 948-53.
[89] Ibid.

The Swedish stock of external assets has developed similarly to the stock of liabilities, with rapidly growing portfolio investments. The main differences are that the assets are less valued than the liabilities (about US$350 billion in 2000) and that the stock of Swedish direct investment abroad is relatively more important than FDI in Sweden. Swedish direct investment abroad holds a share of around 30 percent of the total asset stock, and FDI in Sweden never increases beyond 20 percent of the total liability stock over the period 1985-2000.

The growth of portfolio investment and the decreasing weight of other investment in Sweden also follow the global trend of securitization, i.e. the transfer of capital via the sale of stocks and bonds rather than loans. The relative weight of equity and debt securities out of total portfolio investment assets and liabilities is also fairly constant over the period. Debt securities have held between 20 and 30 percent of the portfolio assets and between 50 and 60 percent of the portfolio investment liabilities.

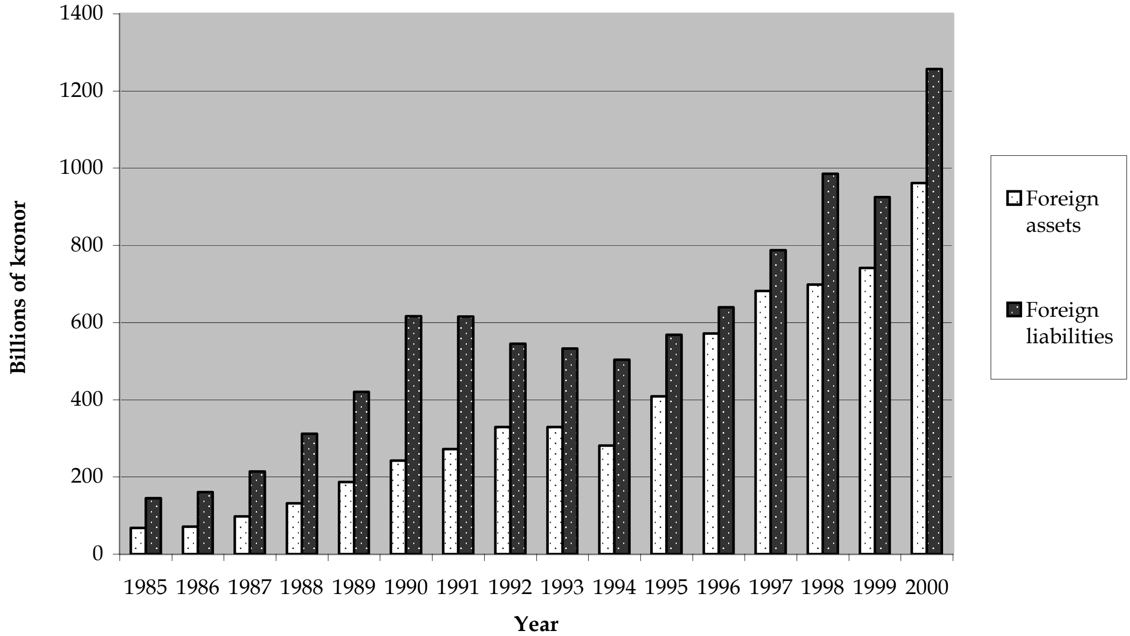
Figure 2: Equity and debt securities as total of Swedish portfolio investment assets, 1985-2000.[90]



Another measure of the effect of the deregulation of foreign exchange controls in 1989 is the development of the stocks of foreign assets and liabilities in "deposit money banks" in Sweden. "Deposit money banks" comprise commercial banks and other financial institutions that accept transferable deposits. As the diagram below shows, there has been substantial growth in both foreign assets and liabilities with a slight dip after the financial crisis of 1992.

[90] Ibid.

Figure 3: Foreign assets and liabilities of deposit money banks in Sweden, 1985-2000.[91]



The development of the Swedish stock market also shows the growing importance of financial markets. The annual turnover on the Stockholm Stock Exchange was 130 billion kronor in 1991 and reached 4455 billion kronor in 2000. The total market value went from 558 billion kronor to about 3580 billion kronor in the same period of time.[92] The share of foreign ownership on the Swedish stock market has also rapidly increased from less than 10 percent in 1985 to close to 40 percent in 2000.[93] Over the same period of time, the number of private shareholders in Sweden has gone from about 2 million in 1985 to almost 7 million in 2000.[94] The number of people exposed to the workings of the financial system is after the reform of the pension system close to one hundred percent.

The last fifteen years have brought global financial markets from the sidelines onto center stage for Sweden. After a slow start, Sweden has followed the same development as most other OECD countries with regard to both financial openness and financial enmeshment. During the Bretton Woods era, Sweden pursued a flexible adjustment strategy that combined openness to trade, regu-

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[91] Ibid.
[92] Stockholmsbörsen, *Stockholmsbörsen over the Last 10 Years, Equities* [Internet] (Olofsson, Marina, July 3 2001, accessed April 29 2003); available from http://domino.omgroup.com/.
[93] Stockholmsbörsen, *Major Owner Categories' Share of Stock Market Value* [Internet] (Olofsson, Marina, July 3 2001, accessed April 29 2003); available from http://domino.omgroup.com/.
[94] Stockholmsbörsen, *Number of Private Shareholders 1980-2000* [Internet] (Olofsson, Marina, July 4 2001, accessed April 29 2003); available from http://domino.omgroup.com/.

lated financial markets, and independent national policies.[95] The hopes of restoring this strategy have effectively been shattered over the course of the last fifteen years. In Ingebritsen's words, "gone are the days when Nordic societies were sheltered from international capital markets by national regulations, when national authorities had the capacity to pursue independent policies."[96] Adjustment and the development of new strategies will continue.

3.4. Conclusion

The impact of global financial flows on economics and politics around the world has increased remarkably in the last few decades. The supraterritorial characteristics of global finance make it one of the key phenomena in the process of globalization. The global financial system has gone through a far-reaching transformation in terms of increasing openness and enmeshment. Financial deregulation and technological advances in communications have made it possible for financial flows to reach further around the globe faster and at a larger scale. This has resulted in increasing enmeshment of most countries in the global financial system.

Sweden was fairly late in initiating deregulation from an OECD perspective but is now one of the most financially open countries in the world. This openness has increased the financial enmeshment of Sweden. Thus, in addition to the traditional Swedish dependence on an open trading regime, its dependence on the working and stability of the global financial system has grown rapidly over the last fifteen years. Sweden has also experienced the full force of speculation, particularly during the financial crisis of 1992.

The volatility of global financial flows and the growing proneness of financial crisis have increased the vulnerability of countries enmeshed in the global financial system. Extracting the benefits while diminishing the costs and risks of global finance has become one of the great political dilemmas of our time.

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[95] On flexible adjustment strategies, see Peter J. Katzenstein, *Small States in World Markets* (Ithaca, NY: Cornell University Press, 1985).

[96] Christine Ingebritsen, *The Nordic States and European Unity* (Ithaca, NY: Cornell University Press, 1998), 75.

Chapter 4: The Swedish Financial Crisis of 1992

4.1. Introduction

The previous chapter analysed recent trends in global finance both internationally and in Sweden establishing that technological advances in communications and the deregulation of financial markets set in motion a far-reaching transformation of the global financial system. Cross-border financial flows have grown tremendously due to increased financial openness and resulted in increased enmeshment of most countries in the global financial system. Sweden is no exception to this trend, although Sweden was relatively late in deregulating its financial markets. In deregulating, the Swedish economy faced the full forces of the global economy. The momentous events of the Swedish financial crisis of 1992 gave the government and population an indication of the downside of the new environment and became the soundboard shaping economic policies throughout the decade. These events are therefore of crucial importance in assessing the impact of global finance on economic policy in Sweden in the 1990s. This chapter analyses the Swedish financial crisis.

The financial crisis that struck Sweden in the early 1990s turned out to be the harshest since the early 1930s. Sweden had in the meantime weathered the financial ordeals of World War II and the two oil crises of 1973-78 and 1979-84 relatively unscathed, but ran into severe problems after deregulating financial markets in the latter part of the 1980s.[1] Swedish banks racked up considerable credit losses after real assets, such as property, turned out to be heavily overvalued.

There are many aspects to the Swedish financial crisis of the early 1990s. Descriptions of the crisis have varied in focus. It has been labelled as primarily a real estate crisis, a finance company crisis, a banking crisis, a currency crisis, and a systemic crisis. The view pursued here is that these smaller crises, while analytically separable, were closely interconnected events that together made up the Swedish financial crisis. In other words, these smaller crises were intrinsic to the overarching systemic Swedish financial crisis. The different aspects of the crisis happened in a relatively short time period. The stakes increased, both for the Swedish population and for the people in charge of getting Sweden out of financial distress, as new problems emerged and rapidly spread to interconnected sectors of the Swedish economy. The financial crisis took hold so quickly that it was very difficult for the government to influence its course. As weeks

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[1] For comparisons of Swedish financial crises, see, for example, Boksjö and Lönnborg-Andersson, *Svenska finanskriser: Orsaker, förlopp, åtgärder och konsekvenser [Swedish Financial Crises: Causes, Courses, Measures and Implications]*; Jonung and Stymne, "The Great Regime Shift,".

and months passed, the crisis became so severe that it shook the foundations of the whole financial system in Sweden.

The financial crisis was a rude awakening for the establishment and citizens alike. Speculators in unknown locations with unknown intentions had stealthily delivered the *coup de grace* to the much-heralded Swedish model. The traditional non-alignment policy that, according to the government, had kept Swedish independence and sovereignty through the violent twentieth century had suddenly proved impotent. Although the government and opposition closed ranks and devised countermeasures, they ultimately failed in staving off the attacks on the currency. It could be argued that Swedish sovereignty had not been so openly and seriously compromised for more than a century. The Nazi troop transportation through neutral Sweden during World War II is probably the closest historical example of compromised sovereignty, but in that case Sweden made the controversial decision to allow it. During the financial crisis, the government made no such decision and was determined to stand its ground.

The financial crisis, which reached its crescendo with the floating of the krona on November 19, 1992, can be seen as the compounded outcome of a stagnating economy paired with a political system unable to adapt to the changing environment. The problems in the Swedish economy had formed and built up over several years. After gathering momentum, they infected and pulled down the whole economy. It was the convergence of long-term structural and short-term cyclical economic and political factors that made up the combustible concoction that Sweden unsuccessfully tried to defuse. Schematically, the crisis in the real estate sector flowed into the finance company sector and their combined problems brought down parts of the banking sector. This, together with the currency crisis and international financial turbulence, threatened the whole financial system and severely compromised sovereignty in Sweden.

The purpose of this chapter is to describe what happened in Sweden during the financial crisis, why Sweden suddenly found itself at the mercy of international speculators, and what the major consequences of the crisis were on both the Swedish economy and policy.

4.2. The acute financial crisis of 1992

Over the last couple of decades, many financial crises occurred around the world. Demirgüç-Kunt and Detraigache, for example, identify thirty major banking crises between 1980 and 1995 and find that financial liberalization increases the probability of a banking crisis.[2] There is a common pattern to many

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[2] Asli Demirgüç-Kunt and Enrica Detragiache, *Financial Liberalization and Financial Fragility* (Washington, D.C.: International Monetary Fund, 1998), Working Paper, WP/98/83.

of these financial crises. Although most of these crises have occurred in developing countries, there are a few examples of crises in developed countries, notably Sweden, Finland, and Norway, which all suffered banking crises in the early 1990s. According to Englund, the common pattern starts with financial deregulation leading to excessive credit expansion. This turns into a sustained increase in asset prices creating a financial bubble. At some point, the bubble deflates and a dramatic fall in prices ensues, causing a disruption in asset markets (for example, the market for real estate) and forcing companies into bankruptcy. This increases credit losses and non-performing loans, which trigger a banking crisis that often is interconnected with a currency crisis. The weakened banking sector tries to regain control of its balance sheets and this brings a credit crunch to the private sector. The impact of this credit crunch depends on the measures the government takes to rescue the banks in financial distress.[3]

In broad terms, the Swedish financial crisis closely followed this general pattern. Consequently, as Jonung points out, the Swedish financial crisis shares many similarities with the subsequent crises in Mexico (1994-5), in Asia (1997), in Russia (1998), in Brazil (1999), in Turkey (2000-1), and in Argentina (2001-2).[4] However, the pattern outlined above does not shed much light on the specific or deeper dynamics at work in the Swedish crisis. As Tirole puts it, "No two crises are identical."[5] Hence, it is important to point out that there is a specific story with a specific set of causes and triggers behind every financial crisis. The conjuncture of these causes and triggers gives every crisis its specific trajectory.

The build-up of the Swedish financial crisis took place over a period of years. In spite of this, virtually no one forecasted the problems into which Sweden was headed.[6] In March 1990, the new director general of the Bank Inspection Board (*Bankinspektionen*[7]) was one of the first to call attention to the risks involved in the failure of a bank or a finance company.[8] Only eight months later his concerns became reality when a large finance company crashed. The failure of the finance company Nyckeln (The Key) is often pointed out as the first sign of a threat to the financial system. After this crash, the crisis gathered momen-

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[3] Peter Englund, "The Swedish Banking Crisis: Roots and Consequences," *Oxford Review of Economic Policy* 15, no. 3 (1999): 80-81.

[4] Lars Jonung, "Misstag utlöste nittiotalskrisen [Mistakes Triggered the Crisis of the Nineties]," *Dagens Nyheter*, 2003-03-09 2003.

[5] Jean Tirole, *Financial Crises, Liquidity and the International Monetary System* (Princeton, NJ: Princeton University Press, 2002), 1.

[6] L. Peter Jennergren, *The Swedish Finance Company Crisis: Could It Have Been Anticipated?* (Stockholm: Stockholm School of Economics, 2001), Working Paper Series in Business Administration, 2001:6.

[7] In 1991, the government merged the Bank Inspection Board and the Insurance Inspection Board and created the Financial Supervisory Authority (Finansinspektionen).

[8] Lars Engwall, "The Swedish Banking Crisis: The Invisible Hand Shaking the Visible Hand," in *Regulation and Deregulation in European Financial Services*, ed. Glenn Morgan and David Knights (Basingstoke: Macmillan, 1997), 181.

tum.[9] Although the general perception at the time was that the crisis happened with only limited warning and that shockwaves reverberated through the Swedish financial system and economy almost immediately, it is *post factum* possible and helpful to delineate different phases of the crisis.

According to Kokko, the Swedish financial crisis that peaked in 1992-93 developed through four phases – the collapse of asset markets, a deep crisis in the financial market, the currency crisis, and a fiscal crisis.[10] These phases are of course only a schematic account of the events and they are both connected and overlapping in time.

The first phase was the collapse of the asset markets. Real estate prices had risen continuously for 15 years when they reached their peak in 1989. In only 18 months, property prices fell more than 50 percent[11] and, over a five-year period, they had lost 75 percent of their value.[12] This development, of course, meant severe problems for real estate companies. For example, more than 40 new real estate companies entered the Stockholm Stock Exchange during the booming 1980s, but close to 75 percent of them experienced serious problems that forced them into bankruptcy or restructuring.[13] Almost simultaneously, the bubble on the stock exchange burst too. The Stockholm Stock Exchange index had risen close to 1150 percent between 1980 and 1989, while the average index in the world had gone up 333 percent. In only three years, the index had halved and a massive amount of capital evaporated.[14]

The collapse of the asset markets brought a deep crisis in the whole financial market and the Swedish financial crisis entered its second phase. The steep downturn in asset markets brought finance companies under stress and this had a direct impact on the banks. The banks had provided part of the funding for the finance companies, so the difficulties of the finance companies became credit losses for the exposed banks.[15] This meant that the downturn of the asset market and stock exchange turned the massive credit expansion of the 1980s into severe credit losses. The aggregated credit losses reached about 200 billion krona between 1990 and 1993.[16] All the big banks, except Handelsbanken, negotiated with the Ministry of Finance in order to secure their survival and main-

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[9] Jonung and Stymne, "The Great Regime Shift," 43.

[10] This typology of the crisis comes from Ari Kokko, "Asienkrisen: Många likheter med den svenska krisen [The Asia Crisis: Many Similarities with the Swedish Crisis]," *Ekonomisk Debatt* 27, no. 2 (1999): 82-3.

[11] Martin Andersson and Staffan Viotti, "Managing and Preventing Financial Crises – Lessons from the Swedish Experience," *Sveriges Riksbank Quarterly Review*, no. 1 (1999): 72.

[12] Kokko, "Asienkrisen: Många likheter med den svenska krisen [The Asia Crisis: Many Similarities with the Swedish Crisis],": 82.

[13] Ibid.

[14] Ibid.

[15] Göran Ahlberg, *Experiences from the Swedish Financial Crisis from a Supervisory Perspective* (Stockholm: Finansinspektionen, 1996), 8.

[16] Johan A. Lybeck, *Facit av finanskrisen [The Result of the Financial Crisis]* (Stockholm: SNS Förlag, 1994), 23.

tain the confidence in the Swedish banking system.[17] However, the credit losses were so severe for three banks – Första Sparbanken, Nordbanken and Gota Bank – that they went into bankruptcy. S-E Banken and Handelsbanken, the two largest banks, had their stock prices slashed by 80 percent, and 200 out of 300 finance companies disappeared from the market.[18]

The third phase was the currency crisis. The boom turned to bust when the asset markets collapsed and the ensuing deep financial crisis weakened the Swedish economy further. As the economic situation deteriorated, the fixed exchange rate seemed increasingly untenable. The government regarded the fixed exchange rate as fundamental to Sweden's economic policy and wanted a clean break with the devaluation policies pursued in the 1970s and 1980s that had stoked inflation and artificially maintained Swedish competitiveness.[19] As a part of a stricter monetary policy, the government had tied the krona toward the ECU (European Currency Unit) in May 1991.[20] For example, Bengt Dennis, the governor of the Riksbank at the time, argues that almost parallel banking crisis and the currency crisis reinforced each other and worsened the crisis.[21] The threat of a systemic crisis was evident in the late summer of 1992.[22] Despite the zealous attempt of the government and Riksbank to defend the krona, including marginal interest rate hikes up to 500 percent, a series of interventions in the market totalling 160 billion krona, and several reform packages to please the market and improve Swedish competitiveness, the krona began its float on November 19, 1992. The krona then lost 25 percent to the German mark (DM) and 40 percent to the US dollar (USD).[23] Just in the six days preceding the floating of the krona, Sweden suffered reserve losses (USD 26 billion) of more than ten percent of GNP.[24]

The fourth phase of the crisis was a fiscal crisis. The bank crisis brought a harsher credit climate with higher interest rates and stricter demands on collateral. Simultaneously, the collapse of asset values led to both low private consumption and business investment. Industrial investment, for example, halved between 1989 and 1993.[25] This resulted in decreasing aggregate domestic demand and increasing unemployment. The boost that the export sector got from

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17 Engwall, "The Swedish Banking Crisis: The Invisible Hand Shaking the Visible Hand," 184.

18 Kokko, "Asienkrisen: Många likheter med den svenska krisen [The Asia Crisis: Many Similarities with the Swedish Crisis],": 82.

19 Magnus Ryner, "Neoliberal Globalization and the Crisis of Swedish Social Democracy," *Economic and Industrial Democracy* 20, no. 1 (1999): 62.

20 Jonung, *Looking Ahead*, 204.

21 Bengt Dennis, *500%* (Stockholm: Bokförlaget DN, 1998), 213-36.

22 Andersson and Viotti, "Managing and Preventing Financial Crises,": 73.

23 Kokko, "Asienkrisen: Många likheter med den svenska krisen [The Asia Crisis: Many Similarities with the Swedish Crisis],": 82.

24 Eichengreen, *Capital Flows and Crises*, 220.

25 Kokko, "Asienkrisen: Många likheter med den svenska krisen [The Asia Crisis: Many Similarities with the Swedish Crisis],": 82-3.

the depreciated krona was not enough to improve domestic demand rapidly. The open unemployment rate[26] exploded from 1.1 percent in June 1990 to 9 percent in June 1993.[27] At the same time, GDP fell a total of 6 percent, which turned out to be the worst recession in Sweden since the 1930s.[28] The rapidly growing unemployment increased the government's expenses while tax revenues dropped. At its peak, the budget deficit reached 12 percent of GDP in 1994.[29]

As mentioned above, the four phases are a stylised description of the crisis. In reality, the phases were overlapping and interconnected. There were clearly many actors and dynamics at work in the chaotic unfolding of the financial crisis. The most dramatic events of the Swedish financial crisis took place in the fall of 1992. At that time, Europe experienced a very turbulent situation in the money market as money traders pushed several European currencies toward the edge. The optimism after the signing of the Maastricht Treaty in February 1992 turned to pessimism and uncertainty about the future of the EMU, when the Danes rejected the Treaty in a referendum in June 1992. The uncertainty brought turmoil to the markets. The turbulence on the financial market reached its peak in September when the British pound, the Finnish markka, the Spanish peseta and the Italian lire had to devalue.[30] In the spring of 1993, traders had attacked eleven European currencies, eight within the ERM and three outside. Only the Belgian franc, the Danish krone, and the French franc resisted attacks. These currencies were neither floated nor devaluated, although their ERM band was widened to 15 percent in August 1993. It was only the German mark, Dutch guilder, and Austrian schilling that were not attacked.[31]

Sweden was in the midst of the European financial turmoil. When the Finnish Central Bank had had enough of the financial turbulence and decided to let the Finnish markka float on September 8, 1992, speculators scoured for the next misaligned currency and zoomed in on the krona, bringing it under tremendous pressure.[32] The currency crisis hit Sweden's economy head on. In only a few frenzied months, interest rates shot up, and Sweden accumulated a huge budget deficit in the public sector. In order to keep the books balanced, the government searched for capital in the international money-lending markets, taking up loans at an annual rate of 200 billion krona. [33]

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[26] "Open unemployment" is a Swedish term that refers to the still unemployed in the labour force, when those participating in labour market policy programmes have been deducted.
[27] Lybeck, *Facit av finanskrisen [The Result of the Financial Crisis]*, 15.
[28] Urban Bäckström, "Finansiella kriser – svenska erfarenheter [Financial Crises – Swedish Experiences]," *Ekonomisk Debatt* 26, no. 1 (1998): 5.
[29] Ibid.
[30] Lars E.O. Svensson, "Fixed Exchange Rates as a Means to Price Stability: What Have We Learned?," *European Economic Review* 38, no. 3-4 (1994): 448-9.
[31] Ibid.
[32] Hinnfors and Pierre, "The Politics of Currency Crises in Sweden,": 109.
[33] Ibid.

A few times in the fall of 1992, the market tested the almost quixotic determination of the Riksbank to hold its ground. After the Finnish devaluation, Bengt Dennis, the governor of the Riksbank, confirmed this resolve in a comment on how far the Riksbank would increase the interest rates in order to defend the krona, when he said "there is no ceiling – the sky is the limit."[34] The first test came on September 16, when the Riksbank had to hike the overnight marginal intervention rate to a staggering 500 percent.[35] This level remained until September 21, when the minority government together with the Social Democratic opposition presented the first of two crisis packages. Although the Riksbank saw the crisis package as insufficient, it was confident enough to lower the rate again to 50 percent.[36] The market interventions needed to defend the krona during the three weeks of currency market turbulence in September 1992 have been estimated to over USD 13 billion.[37] The krona was temporarily out of harm's way and the hard currency aspirations among the defenders were still intact.[38]

However, the relative calm on the money markets would only remain for a couple of weeks. In mid-November, speculation on a Swedish currency crisis had gathered new force. According to Stern and Sundelius, the governors of the Riksbank decided at a morning meeting on November 19 to raise the marginal interbank rate to 20 percent and purchase krona in the market. This forceful intervention did not stem the outflow of currency.[39] The currency outflow has been estimated to the equivalent of USD 26 billion or 11 percent of Sweden's GNP in the six days preceding the float.[40] The massive outflow, of course, severely strained the foreign currency reserves. Later on November 19, a new meeting was convened, and this time it was clear for the participants that they were fighting a losing battle. The measures available were not sufficient to defuse the crisis. Instead, the independent bank board of the Riksbank took the pivotal decision to discontinue the krona's tie to the ECU (European Currency Unit) and let the currency float freely when the New York money market opened for the day. Only thirty minutes of trading remained on the Swedish currency market after the announcement, and the krona fell 10 percent. In the next couple of days, the krona was down 20 percent. At the same time, the Stockholm stock exchange gained 4 percent after the announcement and another 9 percent the next day.[41]

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[34] Nils Eric Sandberg, "Fyrahundranittio procent för mycket [Four Hundred Ninety Percent Too Much]," *Dagens Nyheter*, 1992-09-17 1992. My translation.
[35] Dennis, *500%*, 50-1.
[36] Ibid., 69-70.
[37] Bank for International Settlements, *63d Annual Report: 1st April 1992-31st March 1993* (Basle: Bank for International Settlements, 1993), 188-9.
[38] Stern and Sundelius, "Sweden's Twin Monetary Crises of 1992,": 32.
[39] Ibid.
[40] Bank for International Settlements, *63d Annual Report*, 188.
[41] Stern and Sundelius, "Sweden's Twin Monetary Crises of 1992,": 32.

Overall, the multiple and parallel currency crises in Europe in the fall of 1992 showed that there was a significant discrepancy between the financial resources at the disposal of governments and central banks in comparison with the vast sums moved by currency traders. For example, the Bank of England replenished its stock of international reserves in order to enhance its capacity to endure a speculative attack with a loan worth 10 billion ECU in D-mark (USD14.5 billion).[42] However, this enhanced support facility was bound to be rapidly exhausted if only a fraction of the traders making up the daily turnover in money markets (about USD1 trillion) decided to move against the pound.[43] Although Sweden managed to secure a 16 billion ECU international loan guarantee with an option of doubling that amount for the same reasons, the resources of a smaller economy such as the Swedish only underline the governmental vulnerability to the whims of the market and the futility in going up against such a massive and elusive opponent. The destiny of Sweden's finances was now at the mercy of the markets.

The most dramatic events of the Swedish financial crisis also became the turning point of the crisis. Once the krona began its float, the freefall of the Swedish economy slowed and the people in charge of Sweden's economic policy could start manoeuvring Sweden out of the detrimental situation. External relations had demanded a strict monetary policy to maintain the fixed exchange rate, while the domestic situation had demanded an expansionary monetary policy to revive the flailing Swedish economy. When the Riksbank defended the currency by hiking the interest rate, it also worsened the domestic financial crisis.[44] This deadlock was broken when the government decided to let the krona float.

After the failure of the economic policy premised on a fixed exchange rate, the old anchor needed to be replaced with a new one. The Minister of Finance, Anne Wibble, favoured an inflation target to foster price stability in order to follow through on the government's goal of turning Sweden from a high to a low inflation economy.[45] The Riksbank already in January 1993 announced the inflationary target of 2 percent annually (within an interval of ±1 percent) commencing from 1995. Although the exchange rate regime had changed, the aim was to quickly establish a new and credible norm for monetary policy.[46]

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[42] Willem H. Buiter, Giancarlo Corsetti, and Paolo A. Pesenti, *Financial Markets and European Monetary Cooperation: The Lessons of the 1992-93 Exchange Rate Mechanism Crisis* (Cambridge: Cambridge University Press, 1998), 56.

[43] Stern and Sundelius, "Sweden's Twin Monetary Crises of 1992,": 36.

[44] Jonung, *Looking Ahead*, 210.

[45] Wibble, *Två cigg och en kopp kaffe*, 37.

[46] Krister Andersson, "Utformningen av inflationsmålet och den penningpolitiska analysramen [The Design of the Inflation Target and the Monetary Policy Framework]," in *På jakt efter ett nytt ankare: Från fast kronkurs till inflationsmål [In Pursuit of a New Anchor: From a Fixed Krona to an Inflation Target]*, ed. Lars Jonung (Stockholm: SNS Förlag, 2003), 250-2, 256-7.

According to Jonung, the Riksbank independently made the decision without any declared support of the Parliament.[47]

During 1993, international interest rates decreased and Swedish interest rates followed them to for Sweden relatively low levels. This slowly eased the monetary situation in Sweden. The economy and the banking system stabilized as the fall in asset values slowed down and more actors could repay debts rather than go bankrupt. However, in the spring of 1994, international interest rates turned up again. This paired with rising inflationary expectations pushed up Swedish interest rates from just under 7 percent to above 12 percent. At the same time, the currency depreciation continued. The new inflation target lacked credibility.[48] In this situation, there was a need for a renewed effort to reform economic policy. Fiscal policy focused on reigning in the rampant budget deficit and regaining control of the spiralling governmental debt, while the government tightened monetary policy.[49] The credibility of the Swedish economic policy grew slowly and this has stabilized the Swedish economy.

It is usually difficult to draw an exact line where a financial crisis starts and ends and the same goes for the Swedish case. The Swedish economy left the brink of disaster relatively soon after the floating of the currency. For example, the banking system went through rapid rehabilitation after the record loss of 50 billion krona for the five large bank groups in 1992. Already in 1994, they turned a profit of 12 billion.[50] Early in 1996, two of the key actors in structuring the support of the banking sector, Stefan Ingves and Göran Lind, were confident enough to declare that "the Swedish banking crisis is over." [51] The acute danger had abated, but throughout the rest of the 1990s, Sweden had to deal with the rehabilitation of the economy after the tumultuous events of the financial crisis.

4.3. The causes of the financial crisis

The dramatic events that unfolded during the financial crisis in the 1990s have spurred a lot of debate regarding the origins and the lack of warning and preparedness of the crisis. According to Larsson, the debate could be described along two dimensions. The first dimension regards whether it was internal or external factors, i.e. whether it was the operation of banks and finance companies or the context and policies framing their operation, which caused the crisis.

[47] Jonung, *Looking Ahead*, 217.

[48] Ministry of Finance, "Regeringens proposition 2000/01:100, Bilaga 5: Finans- och penningpolitiskt bokslut för 1990-talet [Government bill 2000/01:100, Appendix 5: Final Accounts of Fiscal and Monetary Policy in the 1990s]," (2001), 21.

[49] Bäckström, "Finansiella kriser – svenska erfarenheter [Financial Crises – Swedish Experiences],": 14.

[50] Ahlberg, *Experiences from the Swedish Financial Crisis from a Supervisory Perspective*, 8.

[51] Stefan Ingves and Göran Lind, "The Management of the Bank Crisis – In Retrospect," *Sveriges Riksbank Quarterly Review*, no. 1 (1996): 5.

The second dimension regards the conflicting perspectives of firm proponents and critics of the market. Market proponents, for example, would stress that regulation and economic policy thwart the market and that bank managers made "mistakes", whereas market critics would stress the necessity of regulation and control for a functioning market, and the greed and mania driving financial actors. Generally, market proponents tended to see external factors as more important than internal factors, whereas market critics tended to see internal factors rather than external factors as more important.[52] What characterizes many of these debates is politicization, ample use of the benefit of hindsight in blaming one party or another, and the possibility of interpreting and promoting what seems ideologically favourable for the future. There is still no agreement on the causes of the crisis. The view pursued here lies somewhere in the nexus of Larsson's two dimensions, rather than in any of the extremes. It was both external and internal factors that caused the crisis and the market was neither completely at fault, nor completely blameless. Rather than being pre-determined, the crisis emanated from the interaction between structural change and agents' actions. As the discussion in the previous chapter on the supra-territorial features of financial globalization showed, this interaction transcends territorial boundaries. The purpose of this section is not to settle this debate, but rather to present the view on the origins of the crisis pursued here.

It is safe to say that there was not one direct reason for the financial crisis. The issue of financial crisis is much too complex. The crisis had built up over a long time and it is therefore difficult to locate and discern more than approximate causes for why Sweden found itself with a financial crisis to manage at a specific point in time. Therefore, in tracing the origins of the crisis, it seems reasonable to separate between causes and triggers when analysing the crisis. This perspective coincides with the Braudelian view that research has to "distinguish between long-lasting movements and short bursts, the latter detected from the moment they originate, the former over the course of a distant time."[53] Braudel separated between three forms of change. They are immediate events that consist of short time-spans, conjunctural trends that span decades, and the *longue durée* that consists of persistent structures stretching across centuries. The specific trajectory of the Swedish financial crisis formed in the interplay between conjunctural trends and the instant. The conjunctural trend reveals itself in an unfamiliar event.[54] For Sweden, the unfamiliar event was the financial crisis.

[52] For a thorough discussion on the different perspectives, see Larsson, "Bankkrisen, medierna och politiken".
[53] Fernand Braudel, *On History*, trans. Sarah Matthews (London: Weidenfeld and Nicolson, 1980), 34.
[54] James N. Rosenau, *Along the Domestic-Foreign Frontier: Exploring Governance in a Turbulent World* (Cambridge: Cambridge University Press, 1997), 24.

In the Swedish case, causes are, for example, the deep-seated structural problems in the economy and the inability or unwillingness of domestic politicians and policies to turn these problems around, whereas triggers are events that set off the crisis at a specific point in time or unveil the problems at hand. One of the key causes of the crisis were the untenable long-term economic environment characterized by high inflation, negative real interest rates, expansionary fiscal policy, and a fixed exchange rate lacking credibility. This environment had its origins in the transformation of the Swedish model that started in the 1970s.[55] Another key cause is the political decision to purge the Swedish economy of these ills through deregulation, disinflation, and a disciplined fiscal policy in order to improve the economic situation in Sweden.[56] Both the growth of global finance, outlined in the previous chapter, and the consensus on monetarist views on economics in most of the Western world[57] at the time were important factors in building the political pressure for policy changes to reform the financial system in Sweden. Sweden was in many ways part of an international trend. The triggers of the crisis are to be found in, for example, the poor timing and effects of the tax reform and external events, such as German reunification and the ERM crisis.

One of the main causes of the Swedish financial crisis was the economic environment that had developed over a number of years. A prime characteristic of this environment was that Sweden experienced a persistently higher level of inflation in comparison with its important trading partners. With a fixed exchange rate regime, the result was an ongoing real appreciation of the exchange rate that forced the government to devalue in order to keep the economy competitive. The government devalued six times between 1973 and 1982. This instantly improved the competitive position for exporting companies, but simultaneously fanned the flames of inflation and fostered expectations of future devaluations. Consequently, when the real appreciation of the exchange rate continued after the last devaluation in 1982, there were high expectations of future devaluations in order to solve to problem of lagging competitiveness among domestic companies. These expectations were reflected in an interest-rate gap with other economies. The actors in the Swedish economy had to pay a higher price to borrow money. Apart from expectations of inflation, the interest rate level is influenced by political and tax-related risks, and foreign and national

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55 Mark Blyth, "The Transformation of the Swedish Model: Economic Ideas, Distributional Conflict, and Institutional Change," *World Politics* 54, no. 1 (2001): 8. Blyth argues further that the Swedish model "destabilized endogenously, absent any large-scale structural changes, when labor began to change some of the basic rights of business in the 1970s."

56 See Carl Hamilton and Dag Rolander, *Att leda Sverige in i krisen: Moral och politik i nedgångstid [Leading Sweden into the Crisis: Morals and Politics in a Recession]* (Stockholm: Norstedts Förlag, 1993).

57 See Kathleen R. McNamara, *The Currency of Ideas: Monetary Politics in the European Union* (Ithaca, NY: Cornell University Press, 1998).

debt. According to Englund, the Swedish one-year interest rate was 1-2.5 percent above the international average during the second half of the century and during periods of currency speculation it rose to as much as 5-6 percent.[58] Furthermore, Sweden had a decisive interest rate gap in comparison with Germany, its most important trading partner. The gap averaged 5.8 percent on three months' interest rates between 1985 and 1990. [59] This high interest rate triggered new price increases and further fuelled the spiralling cost and wage level. Weak government finances and budget deficits in the 1980s also affected both the interest rate and the exchange rate credibility negatively.

The tax system cushioned and spread the costs of the high inflation and interest rates. The tax system had full deductibility of interest payments, which made real after-tax interest rates low or negative. Thus, there was a vested interest in keeping the economic order among those who could use it to their benefit. People averse to credit saw their savings deteriorate in bank accounts, whereas those willing to take loans benefited, since inflation and the tax system rapidly diminished their loans while their real assets appreciated. In the early 1990s, Swedish households experienced a positive cost for borrowing money for the first time in three decades.[60] This environment had fostered a willingness and preparedness to be a part of the credit-expansion in the late 1980s also among the credit averse. It is indeed remarkable that the economy could function as well as it did on those premises and for such a long time. Under these circumstances, the regulated financial market had been essential for the working of the economy.

As pointed out in the previous chapter, Swedish deregulation in the late 1980s unleashed a pent-up demand for credit. The development of new financial instruments and the deregulation of the financial markets opened up the floodgates for credit into the previously financially-sheltered Swedish economy. Credit became available from sources other than the banks. When credit-fuelled investment and demand for goods and services reached the capacity to produce or supply assets, prices started to increase. From 1986 to 1990, lending rose by 136 percent (73 percent in real terms). There were new opportunities for competition and the previously most regulated institutions expanded rapidly in the new environment. This meant that banks and mortgage institutions expanded more than finance and insurance companies that had thrived on the regulated market. With the entry of banks, finance companies had to pursue higher-risk markets. Finance companies were not allowed to receive deposits or issue bonds. This meant that either they financed their operation through direct borrowing from the banks or through issuing company investment certificates

[58] Englund, "The Swedish Banking Crisis: Roots and Consequences,": 81.
[59] Boksjö and Lönnborg-Andersson, *Svenska finanskriser: Orsaker, förlopp, åtgärder och konsekvenser [Swedish Financial Crises: Causes, Courses, Measures and Implications]*, 41.
[60] Englund, "The Swedish Banking Crisis: Roots and Consequences,": 83.

(marknadsbevis). The banks usually guaranteed these certificates and, consequently, banks indirectly increased their exposure to credit risk.[61]

Lending in foreign currency also increased from 27 percent to 47.5 percent of total bank lending between 1985 and 1990. In this period, the law prohibited the government to borrow abroad in order to finance budget deficits, which meant that domestic interest rates had to be sufficiently high to make private borrowing in foreign currency attractive. This meant that the private sector took on considerable exchange-rate risk.[62] In this environment, it is fair to say that all actors increased their risk exposure.

The deregulation in 1985 has been the main culprit in many explanations of the crisis, especially among pundits on the left wing of the ideological spectrum.[63] With the condition of the Swedish economy in mind, however, this seems to be too one-dimensional an explanation. Deregulation or not, the Swedish economy was heading into a financial crisis of some kind. Rather than causing the crisis, the deregulation was a reaction to the deteriorating economic situation and channelled the crisis in a different direction than it would have gone if the economy had remained regulated. It is important to point out that it was the combination of years of overly expansionary fiscal policy, a monetary policy managing a fixed exchange rate, and a tax system that produced negative real interest rates in an environment of high inflation rates that created and fuelled the boom. The deregulation amplified the boom when it was already in the works through increasing competition among financial actors, less rigorous risk assessment in order to maintain market shares, and excessive lending.[64]

In retrospect, the deregulation seems to have been inevitable due to the rise of global finance and the inefficient Swedish capital markets, but it came to have a larger than necessary impact on the crisis because it was conducted too late, in a boom, and before the reform of the tax system. In his memoirs, Ingvar Carlsson concedes that his prioritizing of other issues than the effects of the deregulation was his biggest mistake during his seven years as prime minister.[65] The financial actors also misperceived the new market situation after the deregulation and, therefore, they had difficulties to both evaluate and adapt to the new risk environment of which they were an intrinsic part.[66] Thus, the deregulation *per se* did not cause the crisis, but a different implementation of the deregulation could have mitigated or averted, rather than augmented the crisis.

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[61] Ibid.: 84-85.
[62] Ibid.: 85.
[63] Peeter-Jaan Kask, *Vägen in i och ut ur krisen: Ekonomisk politik från Feldt till Persson [The Road into and out of the Crisis: Economic Policy from Feldt to Persson]* (Stockholm: Rabén Prisma, 1997), 49.
[64] Englund, "The Swedish Banking Crisis: Roots and Consequences,": 95.
[65] Carlsson, *Så tänkte jag*, 260.
[66] Larsson and Sjögren, *Vägen till och från bankkrisen*, 201.

The triggers of the crisis are to be found when the boom turns to bust and the bubble deflates. Although there were no signs of an approaching financial crisis in the fall of 1989, there was recognition that the economy was overheated. The open unemployment rate had reached the record low level of 1.4 percent in 1989, and inflation was continuously higher than in other countries. There was only limited support in Parliament for a more restrictive fiscal policy and monetary policy was restricted by the fixed exchange rate, which had increasing credibility problems. But still, nothing in the financial market signalled an imminent crisis.[67]

In Kindleberger's vocabulary, Sweden experienced a time of euphoria and mania.[68] The bubble inflated rapidly and this was most clearly visible in the real estate sector, but also on the stock exchange. The gains of others in this boom, be they firms or neighbours, triggers others to join the indulgence. As segments of the population that are usually indifferent to speculative undertakings join in, a fully-fledged mania develops leading. Sweden showed clear examples of mania, especially among fiercely competing banks that threw loans at anyone willing to join the credit-fuelled upward spiral.

In the euphoric days of boom, it is always difficult to deliver the gloomy forecasts or publicly describe the speculative moment for what it is. It is even more problematic politically to take sufficient precautionary action. In the short run, Galbraith argues, any such warning "will be said to be an attack, motivated by either deficient understanding or uncontrolled envy, on the wonderful process of enrichment. More durably, it will be thought to demonstrate a lack of faith in the inherent wisdom of the market itself."[69] Despite this, there seems to have been forces within the government that to some extent recognized the problems in the Swedish economy and attempted to do something about them. The deregulation, tax reform, and process of disinflation were believed to be parts of the cure for the structural problems in the Swedish economy. However, there also seems to have been a lack of understanding of the scale of the problems and underestimation of the forces unleashed among the reformers. For example, according to Jonung, neither experts at the Ministry of Finance, the Riksbank and the National Institute of Economic Research (Konjunkturinstitutet), nor economists at universities and banks managed to predict the coming financial crisis for the simple reason that they had no experience of the weight of the forces unleashed through the financial deregulation of the Swedish economy.[70]

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[67] Englund, "The Swedish Banking Crisis: Roots and Consequences,": 89.
[68] See Kindleberger, *Manias, Panics, and Crashes*.
[69] John Kenneth Galbraith, *A Short History of Financial Euphoria* (New York, NY: Whittle in association with Penguin, 1994), 2.
[70] Lars Jonung, "Kronfallet som skakade Sverige [The Fall of the Krona Shook Sweden]," *Dagens Nyheter*, 19 November 2003.

In this overheated environment, the political decision to reform the tax system was taken in the fall of 1989.[71] Although the implementation of the tax reform did not come through until 1990-91, it immediately lowered the expectations of inflation and was an important part of the process of disinflation. The reform, labelled as "the tax reform of the century", had the deliberate intention of encouraging private saving and discouraging loan-financed investment.[72] The first element of the reform was the further reduction of deductibility of interest payments, which would make borrowing less attractive. The second element was a large shift in the direction of indirect taxation in combination with a lowering of the top marginal rates of income taxation.

According to Jonung, the process of disinflation was a consequence of both policy choices and external events and resulted in a sharp increase in real interest rates.[73] When the real interest rate goes up, the value of real assets, such as property, goes down. The rapid increase in real interest rate that the process of inflation brought about undermined the financial system, and the real estate bubble was about to burst in the fall of 1990. Swedish policymakers also committed very strongly to not accommodating the overheated domestic economy through lax monetary and fiscal policies. The previous solution to solve the deteriorating relative cost situation for the Swedish export industry had been devaluation. The major political parties denounced this option and did not want a repetition of the devaluation episode of 1981-2.

The shift in the Social Democratic government's priority from low unemployment to low inflation became obvious in October 1990 when large currency outflows forced the Riksbank to hike interest in order to defend the krona.[74] The currency outflow signalled the lack of market confidence in the Swedish economy. The government tightened fiscal policy and proposed unusually comprehensive measures to address the problems to simultaneously improve both its credibility and the financial market impression of Sweden. The proposal included shifting priorities in economic policy, constitutional amendments, energy policy, and the declaration of the intent to seek membership in the European Community.[75] The government decided in May 1991 to unilaterally peg the krona to the ECU in an attempt to strengthen its commitment to reducing inflation and make the first move towards participation in the ERM and EMS.[76] The intention was to further enhance Sweden's tarnished credibility, rule out

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71 Boksjö and Lönnborg-Andersson, *Svenska finanskriser: Orsaker, förlopp, åtgärder och konsekvenser [Swedish Financial Crises: Causes, Courses, Measures and Implications]*, 43.
72 Jonung, *Looking Ahead*, 208.
73 Jonung and Stymne, "The Great Regime Shift," 39.
74 OECD, *OECD Economic Surveys 1991-1992: Sweden* (Paris: Organisation for Economic Co-operation and Development, 1992), 39.
75 Carlsson, *Så tänkte jag*. Interview with Carlsson, 2004-02-11.
76 Jonung and Stymne, "The Great Regime Shift," 39; OECD, *OECD Economic Surveys 1991-1992: Sweden*, 45.

future devaluations, and in the long term turn the krona into hard currency. The idea was also that the ECU peg would import price stability from Germany and improve the chances for a successful EU application.[77] The elimination of capital controls in 1989 meant that this commitment was under constant scrutiny in global financial markets. Decisions to act and not to act can be equally influential in triggering a crisis, and the Swedish government's decision not to accommodate the overheated domestic economy was a clear trigger for the crisis that followed.

According to Englund, the various triggers of the crisis were either internal or external to the boom in the Swedish economy. Internal to the boom were, for example, the skyrocketing asset prices, the high inflation rate, and contractionary fiscal policy. As mentioned above, the inflated asset prices had induced over-building. At some point, this led to over-supply, leading to vacancies and falling commercial rents. This, of course, turned the upward spiral down and led to distressed sales because of low equity in the real estate sector, which clearly aggravated the price fall. The boom had also stoked the already high inflation rate, which continued real appreciation of the exchange rate and reduced credibility in the fixed exchange rate. Sweden had developed most of the characteristics preferred by prowling international speculators. The currency crisis that followed had a direct impact on fiscal policy. Fiscal policy contracted in 1992 after years of expansion. These factors were internal to the boom and decisive in tipping the scales from boom to bust.[78]

External to the boom were two important factors that together forced up real interest rates. The first factor was a domestic policy shift. In 1990-91, the aforementioned tax reform had a strong impact on post-tax interest rates. The second factor was a consequence of globalizing financial markets. The high international interest rates triggered by, for example, the German reunification and the ERM crisis led to increasing interest rates also in Sweden. The conjuncture of these factors triggered a strong real interest shock that hit the cash flows of bank customers while the value of their collateral plummeted. Falling creditworthiness became negative equity, and non-performing loans turned into bankruptcies.[79]

Global developments were independent of the Swedish financial crisis, but played a significant role as triggers in the Swedish crisis. Indeed, global developments are the backdrop of most political decisions.[80] Most of the problems in a smaller open economy such as Sweden's are to some extent dependent on global developments, especially in the economies of the major trading partners. There are many examples of these events that influenced the Swedish economy

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77 Buiter, Corsetti, and Pesenti, *Financial Markets and European Monetary Cooperation: The Lessons of the 1992-93 Exchange Rate Mechanism Crisis*, 57.
78 Englund, "The Swedish Banking Crisis: Roots and Consequences,": 96.
79 Ibid.
80 Katzenstein, *Small States in World Markets*, 24.

at the time beyond the already mentioned German reunification process and the ERM crisis. For example, the Gulf War pushed up interest rates and oil prices; the Danish rejection of the Maastricht treaty created uncertainty about the EU project and Sweden's participation therein; and the Finnish decision to let the markka float that increased the speculative pressure on Sweden. These were all significant events beyond Swedish control that triggered and augmented the Swedish crisis. The Swedish vulnerability to developments in global financial markets had increased further after abandoning the currency regulations in 1989. Faced with a weakening domestic situation and a high price level, Swedish investors could now find better returns abroad, leading to an outflow of Swedish kronor. This outflow was not balanced by foreign investments into Sweden, though, since Sweden was no longer as attractive to foreign investors as it had once been.[81]

It was not a traditional domestic run on the banks that triggered the crisis in the banking system. Instead, as Urban Bäckström, who was under secretary at the Ministry of Finance during the crisis, argues, it was an international lack of confidence in the Swedish economy and difficulty raising capital in international markets that brought the banking sector to the brink of disaster. Some Swedish banks had difficulties, due to their growing credit losses, to service their foreign loans, and this was a complementary reason for the coincidence of the banking crisis and the currency crisis in the fall of 1992.[82]

There has been a lot of confusion about who triggered the currency crisis in the fall of 1992. At the time, it was unclear whether the charge on the krona came from abroad or had domestic origins. However, domestic traders usually have better information about what is going on in their country and therefore they are usually the first to exit. Their market move alerts international traders that follow their path on the expectation that domestic actors ought to have better information. It is both the scale of their resources and the synchronization of their exit that make international traders deliver the decisive strike. The urgency to get out of a currency position in order to cut losses builds up the overwhelming pressure. Sweden experienced the same herd behaviour in the currency crisis. Among the international actors blamed for the failure of the Swedish currency are individual financiers, such as George Soros, and American pension funds,[83] but this is only partly true. In November 1992, domestic companies, such as Electrolux and Volvo, and banks, such as S-E Banken, had lost confidence in the ability of the Riksbank to hold the peg to the ECU.[84] In leaving

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[81] Boksjö and Lönnborg-Andersson, *Svenska finanskriser: Orsaker, förlopp, åtgärder och konsekvenser [Swedish Financial Crises: Causes, Courses, Measures and Implications]*, 56.
[82] Bäckström, "Finansiella kriser – svenska erfarenheter [Financial Crises – Swedish Experiences],": 12.
[83] Anders Olsson, "Svenskar startade kronattack [Swedes Started the Attack on the Krona]," *Dagens Nyheter*, 7 September 2002.
[84] Ibid.

the krona, they offloaded their currency risk, but they simultaneously alerted international traders which effectively brought pandemonium to the Swedish economy. Sensible behaviour on the short-term micro/company level turned out to have devastating long-term effects on the macro level. When a state faces a financial crisis on a deregulated financial market, the enemy is as much within as it is without the boundaries of the state. In retrospect, the steadfast determination of the Riksbank to stand its ground and defend the fixed value of the krona against the onslaught of elusive traders seems foolhardy.

There were clearly many factors involved in causing and triggering the Swedish crisis. Through the 1990s, there has been plenty of debate about what causes and triggers were necessary, complementary or insignificant in the development of the Swedish financial crisis, and this debate will continue. In all, the origins of the crisis lie in the globalizing financial market, lagging productivity and competitiveness of the Swedish economy and the domestic policy changes launched in an attempt to improve the situation. It was the conjuncture of these structural problems and specific domestic policy measures, international events and speculation that triggered the crisis at a specific point in time.

4.4. Consequences of the financial crisis

The financial crisis left Sweden with a plethora of economic and political problems. The Swedish population, used to the provisions of a far-reaching welfare state in the, so-called, Swedish model[85], came to realize the fragility of their situation as the government scaled back benefit levels and social programs.[86] The government's ability to shelter the population had proven limited in a deregulated global financial market and the prospects for the Swedish economy looked grim. The fall in national prosperity in comparison with other countries continued, and any turnaround seemed distant. [87] In the aftermath of the crisis, there was also a sense of vulnerability to global forces that were beyond the reach of Swedish politicians.[88] Their pursued lines of defence had been penetrated and discredited. The effort to fend off the attack on the Swedish krona seemed all the more insufficient, futile and naïve after realizing the forces at hand.

In any discussion of the consequences of a financial crisis, it is difficult to discern the connection of a later development to the financial crisis. For example, if unemployment increases because of the financial crisis and remains high over the following decade, it is problematic to make sure whether it is the finan-

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[85] For excellent discussions on the development of the Swedish model, see, for example, Blyth, "The Transformation of the Swedish Model,"; Ryner, "Neoliberal Globalization,".
[86] Hinnfors and Pierre, "The Politics of Currency Crises in Sweden,": 114.
[87] For example, the economists Hamilton and Rolander estimated that it would take until 2013 before the turn from a high inflation economy to a low inflation economy would start paying off in higher GDP. Hamilton and Rolander, *Att leda Sverige in i krisen*, 97, 115.
[88] Wibble, *Två cigg och en kopp kaffe*, 39.

cial crisis *per se*, failed policies in the aftermath of the crisis, or some factor unrelated to the crisis, that caused the high unemployment. Any direct linkage fades with time. Therefore, it is important to point out that a financial crisis is rarely, if ever, the original or the sole cause of the problems, but rather a factor among others. Regardless of the actual/objective connection, what matters the most in a discussion of consequences is what the participants and debates in the aftermath of the crisis focused their attention on. The reason is that their understanding of the consequences of the crisis is at the basis for any attempt to reform and improve policies, the urgency of this process, and the direction of new strategies to meet the perceived threat.

The most obvious and profound economic policy change that the Swedish financial crisis produced is the floating currency regime. As mentioned above, Sweden succumbed to speculative attacks in 1992 and had to let the krona float, despite the valiant effort of politicians and the Riksbank to save the fixed regime. It was the first time since 1933 that the Riksbank had to work under a floating currency regime.[89] In applying the new rules of the game, the new goal at the Riksbank became to maintain price stability, i.e., the adherence of a low-inflation norm. The Riksbank has so far been successful in meeting this goal, which means that inflation has been under control, interest rates have come down and the krona has regained some of the lost strength. Furthermore, this shift in policy has changed the path a future financial crisis would follow, even if the outcome of the crisis could be equally devastating regardless of exchange rate regime.

With a floating exchange rate regime, it was necessary to create a new framework for monetary policy. Already in January 1993, the Riksbank decided to introduce a quantitative target for inflation. The prototype for this framework came from Canada and New Zealand. The target for inflation measured with Consumer Price Index became 2 percent with a symmetric interval of ±1 percent. The target was officially implemented from 1995, rather than immediately. The reason was that the inflationary pressure created primarily by currency depreciation would give the policy little chance to succeed. However, the Riksbank immediately set out to bring the economy on course to reach the new target on time.[90]

In order to improve the ability of the Riksbank to fulfil the task of maintaining price stability, the Parliament changed the law and thereby strengthened the independence of the Riksbank as of January 1, 1999.[91] This increasing independence is both a part of the Swedish convergence to the rules of the European Monetary Union and a part of the monetarist focus on norms to in-

[89] Dennis, *500%*, 198.
[90] Ministry of Finance, "Regeringens proposition 2000/01:100, Bilaga 5," 21.
[91] Sveriges Riksbank, *Safeguarding the Value of Money* [Internet] (Sveriges Riksbank, 2003, accessed January 24 2003); available from www.riksbank.se.

crease credibility. The idea is to keep the central bank at arms length from politicians, so that no sudden swing in the opinion polls should tempt politicians to tamper with the economy to gain short-term benefits. The intention of a more independent central bank was to send a positive signal to the financial markets and potential investors. The last couple of decades, many countries have given their central banks a more independent role and Sweden is following this general international trend.[92] As more and more OECD countries have taken this position, it has become increasingly difficult to keep a dependent central bank. In that respect, it was not a controversial decision to increase central bank independence in Sweden.

The dramatic consequences of the financial crisis have influenced or been the backdrop of most policy-decisions throughout the 1990s. However, the consequences are probably best captured in bare, quantifiable facts. The number of bankruptcies, for example, increased rapidly during the crisis. In 1989, a total of 6,879 companies went under. After an explosive increase, the company bankruptcies peaked in 1992, when more than 21,200 companies failed. In the sector containing finance, insurance, real estate and business services, this development was even more striking. The sector experienced a fivefold increase in annual bankruptcies between 1989 and 1992. More than 4,300 companies went under in this sector in 1992 alone. In total, more than 70,000 companies failed during the period 1991-1994, and more than 12,000 companies went out of business in the financial sector.[93] This development had serious consequences for the Swedish economy. It is a vital part in any explanation of the increasing rate of unemployment, the mounting credit losses for the banks, and the negative growth rates. As the economy recovered in the aftermath of the crisis, the bankruptcies have come down to a more normal level again. In 1999, less than 6,700 companies failed.[94]

The crisis also brought Swedish unemployment up to levels long forgotten. On average 75,000 people or 1.6 percent of the labour force was unemployed in 1990. At the peak in 1993, average annual unemployment had increased almost five times to 356,000 people or 8.2 percent of the labour force. The economic recovery in the aftermath of the crisis has improved the situation and unemployment has come down and in 2000, there were 203,000 people or 4.7 percent unemployed. [95] It seems unlikely that Swedish unemployment will reach the remarkably low level experienced in 1990. Rather, the unemployment rate is now closer to the average EU level.

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[92] Sylvia Maxfield, *Gatekeepers of Growth: The International Political Economy of Central Banking in Developing Countries* (Ithaca, NY: Cornell University Press, 1997).
[93] Statistics Sweden, *Statistical Yearbook of Sweden 1996*, vol. 82 (Sundbyberg: Statistics Sweden, 1995), 337.
[94] Statistics Sweden, *Statistical Yearbook of Sweden 2002*, vol. 88 (Sundbyberg: Statistics Sweden, 2001), 482.
[95] Ibid., 252.

This seemingly positive development in the aftermath of the crisis hides the rapid increase in the 1990s of people outside of the labour force. In 1990, about 830,000 people had for some reason given up looking for work and were outside of the labour force. This number had increased more than 55 percent by 1998, when it reached 1.31 million people. In 2000, the number was down to 1.24 million people. The number of people outside the labour force coincides fairly well with the employment ratio[96], which fell from 83 percent in 1990 to less than 71 percent in 1997 and thereafter increased somewhat to about 74 percent in 2000.[97] The number of people of working age that do not contribute with employment-related taxes and are dependent on the welfare state have increased tremendously over the decade.

The loss of jobs in the immediate aftermath of the crisis happened in both the public and private sector. The number of employees in the public and private sector was rather steady in the 1980s, but started to fall rapidly during the crisis and continued to fall through the 1990s. The number of public sector employees was 1.64 million in 1985[98], 1.65 million in 1990, and fell to 1.39 million in 1994. The number diminished further to 1.32 million in 2000. [99] After a steady development in the 1980s, private enterprise employees experienced a similar fall during the crisis. There were 2.32 million private enterprise employees in 1985[100] and the number was 2.42 million people in 1990. In the turbulence created by the crisis, the number of private enterprise employees fell to its lowest point of 2.03 million people in 1993. However, after the crisis private enterprises have employed more people and employment increased to 2.40 million in 2000. [101] The private sector has thus increased its importance as employer, whereas public sector employment has continued to decrease in the years following the crisis.

Unemployment during the crisis hit men more severely than women. In 1990, when only 1.6 percent of the labour force was unemployed, there was almost exactly the same percentage of men and women unemployed. When unemployment peaked at 8.2 percent in 1993, 9.7 percent of men were unemployed whereas only 6.7 percent of women were unemployed. As the economy has recovered from the crisis, unemployment is becoming more even between men and women. In 2000, the overall unemployment ratio[102] had gone down to 4.7 percent, but men had an unemployment rate that was relatively higher with

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[96] The employment ratio measures the number of people employed divided by the total working age population (16-64 years).

[97] Statistics Sweden, *Yearbook 2002*, 252.

[98] Statistics Sweden, *Statistical Yearbook of Sweden 1995*, vol. 81 (Sundbyberg: Statistics Sweden, 1994), 171.

[99] Statistics Sweden, *Yearbook 2002*, 257.

[100] Statistics Sweden, *Yearbook 1995*, 171.

[101] Statistics Sweden, *Yearbook 2002*, 257.

[102] The unemployment ratio measures the percentage of unemployed in the labour force.

5.0 percent and women lower with 4.3 percent.[103] The most persistent problem in the aftermath of the crisis has been an unemployment level that is unusually high for Sweden. It seems that the extremely low unemployment levels of between 1-3 percent are now history.

The earlier very ambitious labour policy in Sweden had to change with the explosive increase of unemployment in the aftermath of the crisis. Sweden came close to "normal" European levels of around 10 percent unemployment, which was previously unheard of. At the same time, the crisis drove the government budget into serious problems. The need to improve the fiscal situation formed the impetus to restructure Swedish policies toward privatising public services, increasing user fees for public services, and lower levels of payouts from the governmental insurances, such as health and unemployment insurance.[104]

The crisis had a huge impact on public finances. When many companies went into bankruptcy and unemployment increased, the stress on the welfare state increased. The so-called "automatic stabilizers"[105] in the Swedish economy probably helped reduce the fall of GDP during and after the crisis. The automatic stabilizers managed to maintain disposable income for households and company profits at relatively high levels. The negative effect was of course that the budget deficit increased rapidly. This created an unsustainable development of the national debt and negatively influenced the credibility of the government's economic policy.[106]

The Swedish state budget suffered severe imbalances during large parts of the decade. The large budget deficits produced in the aftermath of the acute crisis forced fiscal policy to focus on budgetary consolidation. The public debt rose to extreme levels in the early 1990s and became the largest among the OECD countries.[107] From a small surplus of 3.4 billion krona at the beginning of 1990, the deficit bottomed out at almost 188 billion at the end of 1992. In 1995/96, the deficit was still above 140 billion krona, but from then on it improved considerably. In order to balance the budget, the government introduced a new law regarding the budget effectively putting a cap on government expenditures in 1996. After seven years of continuous deficits, the budget had a small surplus in 1998 and has been close to balance or in surplus since then. The surplus reached 102 billion in the boom year of 2000.[108]

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[103] Statistics Sweden, *Yearbook 2002*, 252.
[104] Schön, *En modern svensk ekonomisk historia*, 507.
[105] Automatic stabilisers are the mechanisms in the economy that reduce the response of GNP to shocks. Textbook examples are income tax, VAT, and unemployment benefits. Whenever income or output fall, the government payments of unemployment insurance rise and receipts of income tax and VAT fall.
[106] Bäckström, "Finansiella kriser – svenska erfarenheter [Financial Crises – Swedish Experiences],": 14.
[107] Jonung, *Looking Ahead*, 283.
[108] Statistics Sweden, *Yearbook 2002*, 350.

The disjointed state budget and the difficulty for the government to adjust to its increasing expenditures and decreasing revenues forced Sweden to increase the state debt rapidly in order to balance the books. At the beginning of 1990, state debt was 582 billion krona and it continued to increase until 1998 when it reached 1,449 billion krona and slowly started to decrease again.[109] This rapidly increasing state debt increased the interest payment part of the state budget expenditure and crowded out other expenses. At the end of 1992, the state spent almost 14 percent of its total expenditure on state debt interest. In 1994, interest payments peaked at almost 19 percent of the total state expenditure. To put it into perspective, the Swedish government spent 26.4 percent of its total expenditure on social security in 1994.[110]

The crisis also had qualitative consequences on the Swedish economy and had, for example, a large impact on the working of the financial market and its actors. The crisis made the actors more restrictive in lending and increased the emphasis on collateral to give credit. This was probably a return to traditionally prudent practices, but was still hard on companies struggling to fulfil the new requirements. In the short term, banks also tried to improve their revenues by increasing their interest rate margin between deposits and loans. All banks suffered from credit losses, so they had more to gain from increasing interest rate margins than they could gain from competing with lower margins. However, over time the high interest rate margin came down as new actors entered the market. In nominal terms, it took until 1998 until bank lending reached the level of 1992.[111]

The trend towards a more market-oriented, rather than the previous banking-oriented, financial system had already started before the crisis. However, as Larsson and Sjögren point out, the crisis reinforced this trend. [112] The interest rate hikes that the Riksbank implemented to defend the krona in the fall of 1992 led many savers to new forms of saving. Instead of only depositing money in the bank, savers saw a need to diversify their portfolios and found alternatives in, for example, different kinds of bonds. In the aftermath of the crisis, many private companies have entered the market for deposits and have highly competitive interest rates. The consequence is that bank accounts to a larger extent have become transaction accounts, rather than savings accounts.[113] With the move toward a more market-oriented financial system, where lenders and borrowers meet directly without the bank as an intermediary, Sweden is consequently following the general trend of disintermediation in global finance.

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[109] Statistics Sweden, *Yearbook 1996*, 247; Statistics Sweden, *Yearbook 2002*, 358.
[110] Statistics Sweden, *Statistical Yearbook of Sweden 1999*, vol. 85 (Sundbyberg: Statistics Sweden, 1998), 249-250.
[111] Englund, "The Swedish Banking Crisis: Roots and Consequences,": 95.
[112] Larsson and Sjögren, *Vägen till och från bankkrisen*, 202-3.
[113] Ibid., 204-5.

The crisis and especially the depreciation of the krona after the currency crisis made Swedish companies and real estate relatively cheap for foreign investors. Both capital flows into the Swedish economy and foreign ownership of Swedish companies increased after the crisis. The effect was further internationalisation of the Swedish economy and in that process Swedish multinational companies have become more multinational and less Swedish.[114]

The Swedish economy began to show alarming signs of bifurcation in the aftermath of the crisis.[115] The depreciation of the krona increased profits, production, investment and employment in the businesses with an international market. However, companies dependent on the domestic market suffered more. High interest rates lowered domestic demand and increased the cost of financing. Private consumption fell and many households and companies had a weak financial position because of the drop in real estate prices. High unemployment and uncertainty on the labour market were important factors in the rapid increase of private saving.

It is impossible to estimate the final cost of the crisis. Estimates of the costs for the bank support[116], credit losses[117], etc. are available, but the total cost for the financial crisis will never be settled. The variables involved are just too many and only rarely do they lend themselves to neat quantification. The damages to the economy, the price for the capital destruction, and the misallocation of resources caused by the severe macroeconomic imbalances are not measurable. The same goes for the cost for lost credibility abroad causing higher interest rates and worse conditions for borrowing. However, what is clear about the cost of the crisis is that the whole Swedish population had to bear it. The price of the crisis had to be paid by everyone, either in the capacity as taxpayer, user of public services, lender, borrower, or shareholder in companies that could not withstand the crisis.

This points towards one of the serious problems with the present crisis-prone financial system: it is not necessarily the ones inflating the bubble and gaining the most from the boom that go on to carry the burden of the bust. There is little correlation between the "crime" of inflating the bubble and "punishment" of paying the price for the crash and, as the financial system is set up, there is of course no avenue to hold domestic or foreign speculators accountable. Thus, the incentive structure works against responsible behaviour. When the consequences of a future financial crisis seem discretionary in their impact as well as difficult to hedge against, it makes sense to try to gain as much as

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114 Schön, *En modern svensk ekonomisk historia*, 516.
115 Kask, *Vägen in i och ut ur krisen*, 121.
116 One estimate of the bank support is 35 billion krona. L. Peter Jennergren and Bertil Näslund, "Efter bankkrisen: Vad blev notan för skattebetalarna? [After the Banking Crisis: How Much was the Bill for the Taxpayers?," *Ekonomisk Debatt* 26, no. 1 (1998).
117 The credit losses of the banks amounted to 12 percent of the Swedish GDP during the crisis. Andersson and Viotti, "Managing and Preventing Financial Crises,": 73.

possible when the bubble inflates. As the realization of this feature of the financial system spreads, it would seem reasonable for more and more people to join in the indulgence as soon as possible in order to reap the benefits. A feedback loop develops and increases financial volatility. This decreases stability and predictability in the financial system (uncontrolled self-oscillation). The result is higher likelihood of bubbles and an increasing magnitude of both bubbles and crashes. In short, the financial system becomes more combustible. With intense boom-bust cycles and volatility in the financial system that keep off-loading the negative consequences on society in general and the ones without funds to join the casino in particular, the financial system harbours an unresolved conflict of interest waiting to erupt. The potential consequences of this conflict go well beyond the deflated bubble and in the extreme include both civil war and interstate war.

Considering the depth of the recession and the gloomy forecast at the time of the crisis, the turnaround in the economic development after the crisis was faster than expected.[118] The Swedish economy contracted for three consecutive years and suffered decisive economic imbalances. This created great uncertainty about the possibility of both getting an economic recovery going and bringing down the high unemployment. However, at the end of the decade, Sweden had had 6 years of growth with an annual average of 3 percent. Unemployment was below 4.5 percent and inflation was low. There was a surplus in public finances and national debt as a percentage of GDP had gone down. The imbalances were eliminated and the prospects seemed promising.[119]

The banking system also recovered remarkably fast after the crisis. All of Sweden's banks ran deep deficits during the crisis and six of them needed to bring in more capital from the state or their owners. The banks suffered more than 155 billion krona in credit losses in the period 1991-1994.[120] One important reason for the quick recovery of the banking system was the bank guarantee that the state extended to all lenders to the banks. Their money was secured with the backing of the state so that Sweden could avoid a liquidity crisis. The Riksbank also deposited a large part of the currency reserves in the banks in order to maintain and potentially recover credibility for the Swedish banking system. The support of the banking system cost 65.3 billion krona, but was balanced by the state's assets and revenue from stocks and capital in Nordbanken, Securum, and Retriva estimated at 60 billion krona in July 1997.[121]

Although the crisis management effort was relatively successful, the financial crisis has had a tremendous impact on Sweden. It is fair to claim that the crisis in the early 1990s has been the backdrop of most economic and political

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118 Hinnfors and Pierre, "The Politics of Currency Crises in Sweden,": 111-3.
119 Ministry of Finance, "Regeringens proposition 2000/01:100, Bilaga 5," 7.
120 Sveriges Riksbank, *Statistical Yearbook 1994* (Stockholm: Sveriges Riksbank, 1995), 24.
121 Kokko, "Asienkrisen: Många likheter med den svenska krisen [The Asia Crisis: Many Similarities with the Swedish Crisis],".

considerations in Sweden ever since. The crisis made it clear that a smaller economy dependent on trade and creditors is extremely vulnerable to the continuous evaluation in global markets of its macro-economic policies and performance. In considering any policy changes, politicians must always take these conditions into account. The dissembling of the Swedish model and the dependence on the whims of global financial markets instilled a new domestic sense of vulnerability, but also cut the international perception of an exceptional Swedish "Third way" down to size. Nevertheless, the rapid economic recovery after the crisis soon also brought new hopes for control and freedom of action for politicians. (For example, the Social Democratic government decided in 1996 to restore benefit levels in some social-insurance programs.)

4.5. Conclusion

This chapter explored what happened in Sweden during the financial crisis of 1992, how Sweden got into the situation it was in, and what the major consequences were. The financial crisis in Sweden built up over many years, affected the whole population, and its consequences influenced Swedish society through the 1990s. It was the conjuncture of long-term structural problems and short-term domestic and international events that set off the crisis at a specific point in time. The economic imbalances created in the aftermath of the crisis took years to settle. The scale of the imbalances and the traditional Swedish reliance on the welfare state spread the effects of the crisis to the whole society. The crisis affected everyone directly or indirectly in their capacity as taxpayers, public service users, lenders, or borrowers. Although the considerable depth and breadth of the crisis provided a bleak forecast for the future, Sweden managed to turn the severe economic imbalances around remarkably fast. At the end of the decade, Sweden had turned gloom into bright prospects and regained the confidence it had lost. This chapter has described the crisis and analysed its causes and consequences. It is now time to turn to the effort to manage the crisis.

Chapter 5: Constrained Choice and Policymaking in the Swedish Financial Crisis

5.1. Introduction

In the previous chapters, the analysis focused on the rise of global finance and the Swedish financial crisis of 1992 in order to understand the development of the situation. The financial crisis severely strained the Swedish economy, and the Swedish government had to take extraordinary measures to manage the situation. With the benefit of hindsight, it is clear that the government misjudged the consequences of a deregulated financial market, the vulnerability of the Swedish economy, and its own abilities to manage the challenges of global financial markets. In dealing with the situation, the government faced strong pressures both from within and from outside the country. The population saw its private assets diminish rapidly, public finances plunged deep into the red, and a large-scale dismantling of the welfare state seemed inevitable. A fast resolution of the financial crisis was necessary. Many actors in the global financial markets, on the other hand, had reaped handsome profits and demanded certain measures to provide fresh capital to the volatile Swedish financial market, as returns seemed more promising elsewhere. The dramatic events of the financial crisis that peaked in the fall of 1992 had caught Swedish decision-makers off guard.[1] In the following months and years, the government had to devise and implement a crisis management strategy in order to regain influence and control over Sweden's economic and political destiny, to win back lost credibility, and to start the arduous restructuring of the stalled economy.

Clearly, the crisis was a decisive event in the modern history of Sweden. From this basis, it is now time to direct attention to the key decisions that the government took in response to the financial crisis. These decisions are fundamental to understanding and evaluating the impact of globalization on the state in this case. The theoretical framework outlined in chapter two assessed four possible approaches to the impact of globalization on the state and then added the approach pursued in this thesis. The established approaches were the powerless state, the sovereign state, the forced adaptation state, and the policy choice state. The approach pursued here is that of constrained choice for the state. From this perspective, the state has to adapt continuously to processes of globalization, but there are choices available for the state in this adaptation. The

[1] For an inside view on the government, see Carl B. Hamilton and Ulrika Stuart, "I stormens öga med strid på flera fronter [In the Eye of the Storm with Battles on Many Fronts]," in *På jakt efter ett nytt ankare: Från fast kronkurs till inflationsmål [In Pursuit of a New Anchor: From a Fixed Krona to an Inflation Target]*, ed. Lars Jonung (Stockholm: SNS Förlag, 2003).

purpose of this chapter is to identify the government's key decisions in response to the financial crisis and then to analyse these decisions in relation to the different theoretical approaches to the impact of globalization on the state.

Selecting the key decisions for the government in this scenario is less than straightforward. Being such a significant event, the financial crisis of 1992 influenced most decision-making to some degree and many decisions could be regarded as of key importance in some respect. However, selecting only a few key decisions is necessary to keep this study manageable and focused on the overall research question of assessing the impact of global finance on economic policy in Sweden in the 1990s. The theoretical approaches outlined in chapter two focus on the interaction between the levels of the global political economy and the state and more specifically on the extent of the impact of global finance on the state. Therefore, the decisions selected are those of strategic character for the government in communicating its intentions to global financial actors targeting Sweden at the peak of the financial crisis.

As argued in chapter four, the government's aim was to resolve the financial crisis while keeping the fixed value of the krona. Three decisions stand out in the government efforts to reach this aim. In chronological order, they are: 1. The decision to support the banks from the summer of 1991, which led to the creation of the Bank Support Authority (*Bankstödsnämnden*) in December 1992;[2] 2. The decision to defend the krona at any cost shortly after the financial market pressure on the currency increased in early September 1992, and lasting until the floating of the krona on November 19, 1992; and 3. The decision to build a broad political coalition during the fall of 1992 in order to back reform packages aimed at easing the financial market pressures and gaining credibility for the efforts. These decisions aimed at conveying to global financial market actors that the government had both the intention and commitment to defend and restructure the Swedish economy. The hope was that this would ease the financial pressure and buy sufficient time to get the Swedish financial system in order without giving up the fixed currency.

These decisions were important as signals both to the external global political economy level and to the internal domestic level. Much of the literature on the Swedish financial crisis has its primary focus on the domestic level and takes the global political economy as a given structure. For example, scholars have focused on the specifics of decision-making[3] or on the political and eco-

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[2] Bankstödsnämnden, *Verksamheten 1 juli 1993-30 juni 1994 [Annual Report: July 1, 1993 - June 30, 1994]* (Stockholm, 1994), 3.

[3] See, for example,Stern and Sundelius, "Sweden's Twin Monetary Crises of 1992,"., Lindgren, "Vad styr ledaren? Om beslutsfattare och policyförändring i säkerhetspolitiska kriser [What Guides the Leader? How Does the Leader Guide? On Decision-Makers and Policy Change in Security Policy Crises]"., and Teorell, "Demokrati eller fåtalsvälde?".

nomic causes and implications of the crisis on the internal domestic level.[4] In order to complement and expand the perspectives of the existing literature, the primary focus here is on the signals and interaction between the global and the domestic level. Although these decisions are interconnected and mutually reinforcing parts of the government's effort to manage the crisis, they are still analytically separable parts in the government's response to the crisis.

The organization of the chapter is as follows. First, the chapter identifies and analyses the key decisions of the government in response to the financial crisis. Second, the chapter evaluates these key decisions in relation to the theoretical approaches on the impact of globalization on the state. Finally, the chapter makes the empirical case for the constrained choice approach as a better way to understand the Swedish government's response to the financial crisis.

5.2. Key decisions responding to the financial crisis

A string of options faced the Swedish government in responding to the development of the financial crisis in the early 1990s. As mentioned above, this section analyses three key strategic decisions that the Swedish government took in response to the financial crisis. There is, of course, no definitive incontestable way to determine which decisions are strategic and which are not, and suggesting that some strategic decisions should be regarded as more important than others will never be free from objections. One could, for example, have chosen strategic decisions from a macro perspective and looked further back in history focusing on the decision to deregulate the Swedish financial market and the lack of restrictive fiscal policy to prevent the forming of the financial bubble (see chapter three); or taken a micro perspective (psychology/anthropology/sociology) focusing on the specific tactical decisions within an overarching strategic decision (see chapter four). However, this dissertation assesses the impact of global finance on the state from a structuration perspective that acknowledges the continuous interaction between structure (global finance) and agency (the state). The criteria used in this study for choosing the decisions are that they all allow a structuration approach, and they came at pivotal moments were the government had to respond to the crisis or jeopardize the Swedish financial system. The first decision – to support the banks and establish the Bank Support Authority – set the stage for further state involvement in the crisis. The evolving financial crisis would have taken a very different trajectory had the government decided that the severe problems in the Swedish banking sector were of a private, rather than a public, nature. The second decision – to defend the fixed cur-

[4] See, for example, Boksjö and Lönnborg-Andersson, *Svenska finanskriser: Orsaker, förlopp, åtgärder och konsekvenser [Swedish Financial Crises: Causes, Courses, Measures and Implications];* Jonung, *Looking Ahead;* Assar Lindbeck and others, *Turning Sweden Around* (Cambridge, MA: The MIT Press, 1994).

rency – was the equivalent of a declaration of war and resulted in the open conflict between global finance and the government. The third decision – to build a political coalition to back the reform packages – was a consequence of the open conflict and a necessary measure to increase the chances of success for the government.

All these decisions are to some extent related and overlapping in that they were responses to a developing situation. However, they were not part of an integrated and pre-planned approach or a standard operating procedure that automatically went into operation as the financial crisis progressed. At each of these points in time there were alternatives and trade-offs to consider, and different factors influenced these decisions as the situation unfolded. As mentioned earlier, Sweden had not suffered a financial crisis of this magnitude since the 1930s. In an official statement, the Riksbank concluded that "there are no current Swedish experiences of how the Riksbank should act in case of a bank failure."[5] There was caution among policymakers in approaching a treacherous development and nothing remotely like a standard operating procedure to deal with the situation. According to Ingves and Lind:

> The methods for resolving the Swedish bank crisis were chosen initially on an ad hoc basis because remedies had to be found without delay for acute situations that at first seemed to be confined to a couple of banks where large sums of money as well as credibility were at stake.[6]

Lacking first-hand practical experience of such a situation, the policymakers and officials resorted to converting foreign experiences and applying them into a Swedish crisis management strategy.[7] Adaptation and learning were important features of the evolving crisis management effort.

The decision to support the banks

The first key decision of the government in response to the financial crisis in Sweden came in the summer of 1991. At that time, it was clear that some important actors in the financial market had serious problems and needed support. First, the state backed the issuance of new shares in Nordbanken during the fall of 1991 in order to get the capital adequacy ratio above the required 7.25 percent.[8] Thereby, the state increased its ownership from 70 percent to 77 percent.[9] Since the state was the main owner of the bank, the significance of the

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[5] Quoted in Dennis, *500%*, 214. The official statement is "The opinion of the Riksbank on the Final Report of the Credit Market Committee of 1989".
[6] Ingves and Lind, "The Management of the Bank Crisis – In Retrospect,": 7.
[7] Dennis, *500%*, 213-5.
[8] Jennergren and Näslund, "Efter bankkrisen,": 70.
[9] Lybeck, *Facit av finanskrisen [The Result of the Financial Crisis]*, 18.

support was less than straightforward and was open to interpretation. Had the state acted in the role of owner providing the necessary capital for the bank to continue its operation or in the role of lender of last resort securing the stability of the Swedish financial system? According to Larsson, the state acted more in the role of owner, but the dual roles of the state sent unclear signals to other financial market actors about what to expect, since the government, at this time, still ruled out any plans on setting up a bank support authority.[10] The question remained whether the state would bail out dysfunctional banks or let them go bankrupt. This is a hard decision for any government. In promising to bail out the banks, the government would create circumstances prone to moral hazard in the banking sector, i.e. the banks would be tempted to take on higher risks in order to increase profits if they knew the state would rescue them from bankruptcy. In letting them go bankrupt, however, the state would risk a bank panic.

The position of the Swedish government was clarified in the middle of October 1991, when it had to decide what do about the problems in another bank. This time Sweden's sixth largest bank, Första Sparbanken, was in serious trouble. The bank reported losses of 4.5 billion krona, the equivalent of 10 percent of its loan stock. [11] The problems were so severe that credit losses threatened to erase the bank's entire capital. The bank needed fresh capital immediately to avoid bankruptcy. The government decided shortly thereafter to support the reconstruction of the bank with an interest-free loan of 3.8 billion krona and, as the problems continued, the government had to warrant an additional loan of 3.5 billion krona to the bank in April 1992.[12] In the case of Första Sparbanken, the government acted strictly in its role as lender of last resort, and the decision clarified the intent of the government to the rest of the financial market. The most obvious alternative had been only to guarantee the depositors' money and let the bank fail.[13] However, the fear of panic in the banking sector threatening the collapse of the Swedish financial system played a decisive roll in the decision to support Första Sparbanken. According to Dennis, the problems at Första Sparbanken were of such magnitude that the Riksbank for the first and only time during the financial crisis took the precautionary measures to manage an imminent run on the bank.[14]

The problems in the banking sector continued, and the government had to support Nordbanken again in the spring of 1992. The state bought out the remaining private shareholders at a cost of 2 billion krona and provided another 10 billion krona to insure the continued operation of the bank.[15] In order to make the bank viable over the long term and halt the credit losses, the state cre-

[10] Larsson, *Staten och kapitalet*, 216.
[11] Lybeck, *Facit av finanskrisen [The Result of the Financial Crisis]*, 18.
[12] Ibid., 18-9.
[13] Larsson, *Staten och kapitalet*, 216.
[14] Dennis, *500%*, 223.
[15] Jennergren and Näslund, "Efter bankkrisen,": 70.

ated a new company, Securum, that took over Nordbanken's outstanding non-performing loans and assets unrelated to banking with the nominal value of 67 billion krona.[16]

In September 1992, the government had to guarantee the operation of Gota Bank. After the bankruptcy of the owner, Gota AB, the state took over the bank at no cost. Again, the entire bank's non-performing credit was allocated in a new company, Retriva, and the state provided the bank with 20 billion krona to continue its operation. In order to minimize the cost and improve the administration, the state merged the now sustainable Gota Bank with Nordbanken in 1993, and Securum bought Retriva in 1996 for 3.8 billion krona – the same amount the state had provided for the operation of Retriva.[17]

The purpose of splitting the bank and moving the unhealthy part of it into a special company was to deal with the credit losses at a later stage when the market had stabilized and then slowly liquidate non-performing credit and other assets. This would minimize the long-term credit losses for both Nordbanken and Securum. For example, the bank became the owner of real estate when the real estate companies went into bankruptcy. Instead of selling the real estate at the going rate immediately on the severely depressed real estate market, the idea was that waiting for the market to stabilize again would diminish the losses. At the same time, the healthy part of the bank could continue developing its operation without threatening the payment system.[18]

The mounting problems for the banks triggered the government's decision to announce a general guarantee for the banking system on September 24, 1992.[19] As Bäckström points out, six out of the seven largest banks in Sweden needed more capital, either from their owners or from the state, to survive.[20] There was an urgent need to improve flailing confidence in the Swedish banking system. The Parliament later approved this guarantee in December 1992. When the Parliament voted on the proposal to support the banks, only 20 members of Parliament did not support it (out of 349 MPs, there were 291 yes, 20 no, 1 abstention and 37 absent).[21]

This guarantee did not extend to the shareholders in banks, but protected all depositors in the banks with no upper limit to the support. The confidence in the solvency of the Swedish state was obviously higher than the confidence in the banks, and this measure aimed to improve the perception of Swedish banks

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[16] Lybeck, *Facit av finanskrisen [The Result of the Financial Crisis]*, 19.
[17] Jennergren and Näslund, "Efter bankkrisen,": 70.
[18] Larsson, *Staten och kapitalet*, 217.
[19] Jonung and Stymne, "The Great Regime Shift," 45.
[20] Bäckström, "Finansiella kriser – svenska erfarenheter [Financial Crises – Swedish Experiences],": 12.
[21] Sveriges Riksdag [The Swedish Parliament], "Protokoll [Record of Proceedings] 1992/93:48, December 18," (http://www.riksdagen.se/debatt/protokoll/index.asp: 1992). The proposal is government bill: 1992/93:135, later legislation SFS 1993:765.

and Sweden's financial system rapidly. With no risk of losses, depositors could continue to provide funds for Swedish banks. After the decision to protect the depositors in the banks, the government focused on spreading the information to rebuild and augment the lagging confidence level at home and abroad. According to Ingves and Lind, both cabinet ministers and officials from the Ministry of Finance and the Bank Support Authority made frequent visits to financial centres around the world to inform financial market actors about the measures undertaken, the development of the situation and the improving economic prospects in Sweden.[22]

There is also an organizational angle to the support of the banks. According to Bengt Dennis, the governor of the Riksbank at the time, neither the Riksbank, nor the Ministry of Finance, nor the Swedish Financial Supervisory Authority (*Finansinspektionen, FI*) predicted the severity and scope of the banking crisis. They had seen increasing problems in the financial sector early on, but they expected the coming adjustment and restructuring to be calmer and more gradual.[23] In September 1992, after consultations with the Riksbank and the FI, the Ministry of Finance decided to treat the crisis as a systemic crisis. The task was to launch the necessary measures to solve the crisis as soon as possible. Preparation had already started in the Ministry of Finance, but it now had to operationalize its plans.[24]

Until the fall of 1992, the Ministry of Finance had managed the banking problems. With a systemic crisis to tackle, it became increasingly important to organize the crisis management effort efficiently. However, as Ingves and Lind argue, the organization of the crisis management effort did not fit very well with the Ministry of Finance structure when the crisis took on system-threatening proportions. The effort would drain the Ministry of Finance of resources and draw attention away from its regular tasks. The situation required competencies other than those that already existed within the Ministry of Finance, because the bank support effort was in many ways technical rather than political in its character. The alternatives were to let either the Riksbank or the FI incorporate the bank support into their domains. Both institutions had knowledge of the financial sector and could quite easily include a crisis management function. However, there were potential conflicts of interest at hand. At the Riksbank, there could be a clash between implementation of monetary policy and different measures to support the bank's financial situation. At the FI, there could be a conflict of interest between the tasks of supervising and monitoring the Swedish banks while at the same time providing bank support to a few of them. In the end, the Ministry of Finance decided to create a new authority, the Bank

[22] Ingves and Lind, "The Management of the Bank Crisis – In Retrospect,": 8.
[23] Dennis, *500%*, 213.
[24] Stefan Ingves and Göran Lind, "Om att hantera en bankkris [On Managing a Banking Crisis]," *Ekonomisk Debatt* 26, no. 1 (1998): 45.

Support Authority (Bankstödsnämnden) that reported directly to the Ministry of Finance.[25]

Overall, the decision to support the banks was tentative and closely followed the development of the financial crisis. There was a clear awareness of the risks involved in letting the banks fail and the importance of safeguarding the functioning of the payment system. Measures were necessary to decrease the threat of a run on the banks, while the banks took on restructuring their operations. While supporting the banks was necessary, the design of the support and its implementation was open to consideration and alternative approaches were available.

The decision to defend the krona

The second key decision in response to the financial crisis was the decision to defend the fixed currency in the turbulent fall of 1992. As is so often the case in financial crises, the banking crisis was not the only financial problem that the Swedish government had at the time. Parallel to the severe problems in the banking sector, the fixed currency came under intense pressure as financial market actors scrutinized a number of supposedly misaligned European currencies. There was an intimate connection between the decision to defend the krona and the conviction of the benefits of purging the Swedish economy of inflation. As was outlined in chapter three, the process of disinflation started with the deregulation of financial markets in the mid-1980s, and policymakers focused on breaking the habit of devaluing the inflated krona to remain competitive. The right-of-centre coalition government, led by Prime Minister Carl Bildt, had won the election on an agenda focused on coming to terms with inflationary pressures from the labour market.[26] However, as the new government took office, Sweden faced the problem of deflation and hence the government's targeting of inflation only exacerbated the problem.[27]

At the time, neoliberal policies were the supposed panacea for the problems in the Swedish economy among most economists, and politicians took this solution to heart.[28] According to Ryner, "monetarism was primarily advocated by the central bank and academic economists."[29] They regarded inflation as the major economic threat and the proposed measures to deal with it were to trim public sector expenditure and let the Riksbank pursue monetary discipline. The effort focused on firmly committing to a fixed value for the currency in order to lower the expectation of inflation and restore domestic and international confi-

[25] Ibid.: 46-47.
[26] Hamilton and Rolander, *Att leda Sverige in i krisen*, 100.
[27] Blyth, "The Transformation of the Swedish Model,": 20.
[28] Hamilton and Rolander, *Att leda Sverige in i krisen*, 101.
[29] Magnus Ryner, "Nordic Welfare Capitalism in the Emerging Global Political Economy," in *Globalization, Democratization, and Multilateralism*, ed. Stephen Gill (New York, NY: St. Martin's Press, 1997), 44.

dence in both the Swedish economy and its banks. Thus, instead of attempting to accommodate the crisis, fierce anti-inflation measures and a fixed currency would establish Sweden as a low-inflation country and low inflation as a new long-term norm.

The financial crisis and particularly the decision to defend the krona became the litmus test of the credibility in the norms the government had laid out. The government was not going to renege on keeping the fixed value of the krona. Prime Minister Bildt explained in September 1992: "We are ready to defend the krona come hell or high water."[30] Both the government and the Social Democratic opposition, that had let the Riksbank peg the krona to the ECU on May 17, 1991[31], backed the Riksbank's staunch defence of the krona. Regardless of the terrain, the government was set on following its map. Hamilton and Rolander have called this refusal to see alternatives "cognitive locking."[32] Ingvar Carlsson, Social Democratic Prime Minister from 1986-91 and 1994-96, confirms the cognitive locking hypothesis in his memoirs, when he writes that giving up the fixed krona was beyond his imagination.[33] The focus on the long-term goal allowed short-term devastation.

As pointed out in more detail in chapter three, the market tested the determination of the Riksbank a couple of times in the fall of 1992. The Riksbank hiked interest rates to levels that would have been previously unbelievable and tried to prop up the Swedish krona with rapidly dissipating foreign currency reserves in order to defend the fixed value of the krona. In the end, the defence of the krona failed, and on November 19, 1992, the krona began its float. The irony of the defence is, of course, that the very market-oriented government did not listen to the market, but tried to defy it. The decision to defend the krona caused more damage to the Swedish economy than was necessary. It made the situation worse for the banks and cost the population a fortune.[34] A common argument for this policy decision is that the long-term gain in credibility would make the cost of defending the currency worthwhile. Indeed, that gain might have materialized had the Swedish government fixed the krona again when the instability had abated, but that has not happened. Instead, the Swedish economy has continued to operate with a floating currency regime. Furthermore, if the government were to fix the currency again now that more than a decade has passed since the crisis, it is highly unlikely that the devaluation risk perception

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[30] Quoted in Thomas Hempel, "Årets match: Politikerna vs marknaden [The Game of the Year: The Politicians vs the Market]," in *Bra Böckers Årsbok 1992* (Höganäs: Bra Böcker/Wiken, 1993), 168. My translation.

[31] Carl Bildt, "Den stapplande vägen till reformer och till Europa [The Stumbling Road to Reforms and to Europe]," in *På jakt efter ett nytt ankare: Från fast kronkurs till inflationsmål [In Pursuit of a New Anchor: From a Fixed Krona to an Inflation Target]*, ed. Lars Jonung (Stockholm: SNS Förlag, 2003), 55.

[32] Hamilton and Rolander, *Att leda Sverige in i krisen*, 12.

[33] Carlsson, *Så tänkte jag*, 312.

[34] Jonung, *Looking Ahead*, 210.

of the Swedish economy established long before the financial crisis would be affected at all by the failed attempt of keeping a fixed currency. The firm defence of the krona meant that the restructuring of the dysfunctional Swedish economy had to wait unnecessarily long for the relief and turnaround inherent in letting the krona float.

The alternative to the decision to defend the currency was, of course, to let the krona float as other currencies succumbed in the currency turbulence in the early fall of 1992 or even earlier. What makes the Swedish government's decision interesting is the refusal to give in despite the circumstances of mounting financial market pressure and a rapidly deteriorating economy, while the Riksbank wore out the interest rate weapon and emptied the currency reserves in vain. Stern and Sundelius point out that the Swedish government attempted to play a game of chicken with the financial market.[35] In signalling its absolute commitment to the fixed krona, the government hoped that the opponent – speculators in the global financial market – would back off and stop the attacks on the krona. In a regular game of chicken, an absolute commitment is enough to make the opponent fold, as there is no way to win the game. However, the government had misinterpreted the opponent in the financial crisis. Actors in the deregulated global financial market would not veer for an uncompromising government backed by the opposition, when there was an opportunity to make money. Thus, while the government followed the proscribed winning formula of a game of chicken and threw out the steering wheel – i.e. raised the interest rate to 500 percent, etc. – the financial market played a different game, leaving the Swedish economy in tatters behind it.

Overall, the choice of defending the krona was a failure that deepened and prolonged the financial crisis in Sweden. It was an inefficient and counterproductive response to the financial crisis. The failure highlights the inability of the policymakers to understand and adapt to the constraints imposed by the financial market. That lesson turned out to be very expensive for the Swedish state.

The decision to build a coalition for reform

The third key decision in the government's response to the financial crisis was to build a political coalition in order to reform and raise domestic and international confidence in the Swedish economy. There is a connection between the decision to build a coalition and the decisions to support the banks and defend of the krona. The problems in the Swedish economy were so severe that the financial markets doubted recovery, and the political system needed to show unity and bolster its credibility in managing the situation. The relative ease the government had in building a political coalition to back joint crisis packages tells us something about the threat perception. Swedish policymakers put party

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[35] Stern and Sundelius, "Sweden's Twin Monetary Crises of 1992,": 36.

politics on hold to save the country and lay the foundations for a functioning financial system.

The building of a political coalition was important because it strengthened the prospects for Sweden to manage the crisis. According to Haggard:

> When countries enter a zone of vulnerability or when crises break, markets are highly sensitive to indications that the government is unwilling or unable to act in a decisive, coherent fashion. Political developments can serve as a trigger or focal point that shifts expectations in adverse ways. Politics can also affect the course of adjustment once a crisis hits, and thus mitigate or compound its severity.[36]

The Swedish economy had entered such a zone of vulnerability and the coalition signalled that the Swedish political establishment was willing and able to act in a decisive and coherent fashion. However, while the political coalition increased the leverage of the Swedish government in responding to the financial crisis, it was still only a precondition for managing the crisis. The substantive policy it produced would be decisive in managing the crisis.

As the Swedish financial crisis deepened, it was very important to have a broad political majority supporting the measures under way. The minority government and the Social Democratic opposition realized that without joint backing of the proposals, it would be difficult to defend the currency. A parliamentarian majority would improve the credibility of the proposed measures in the financial markets.[37] The officials at the Ministry of Finance therefore continuously informed both sides and encouraged them to give input on the preparations and implementation of the Ministry's measures. The Ministry of Finance also proposed to earmark two seats on the board of the Bank Support Authority for the opposition in order to further involve them and avoid making the measures a political battlefield in the coming election.[38]

The framework for a coalition started to form as the turbulence increased on the foreign exchange markets. The day after Finland was forced to let the markka float (September 8, 1992), both the government and the Social Democrats expressed their support of the fixed krona and announced that they would start deliberations on economic policy. Soon the Riksbank could lower its interest rate from 75 percent to 20 percent.[39] This lowering of the interest rate points toward open lines of communication between the policymakers and actors in the financial market. Obviously, the financial market takes input from many

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[36] Haggard, *The Political Economy of the Asian Financial Crisis*, 47.

[37] Bildt, "Den stapplande vägen till reformer och till Europa," 62-3; Carlsson, *Så tänkte jag*, 483.

[38] Ingves and Lind, "Om att hantera en bankkris,": 46.

[39] Ministry of Finance, "Regeringens proposition 2000/01:100, Bilaga 5," 18.

sources, but one interpretation of the lowering of the interest rate is of a market approval of the formation of the coalition.

On September 16, 1992, later dubbed "Black Wednesday" because of the severe turbulence on many European currency markets, the pressure on the krona mounted again.[40] The British pound had to leave the ERM. The Riksbank hiked interest rates initially to 75 percent and then to 500 percent to stop the currency outflow and hold the fixed value of the krona. The outflow continued the following day and the Riksbank decided to hike the interest rate all the way to 4000 percent if necessary.[41] The same evening there was an announcement that negotiations about how to end the crisis had started between the government and the Social Democrats.[42] They jointly presented the crisis package on September 20, 1992. The urgency of the situation had made a coalition possible, and in just a few days they ironed out reforms to fend off further attacks on the krona.

"Crisis Package 1" set out to strengthen the budget with close to 20 billion krona through a combination of lower public expenditure and higher taxes. Some measures were effective immediately, while others would be implemented later. Again, the Riksbank could lower the interest rate to 50 percent and then, a few days later, to 40 percent.[43] The market reaction was now the key instrument to evaluate the efficiency of the measures and it indicated at least temporary alleviation.[44] The problems in the banking sector were still disastrous and this forced the government with the support of the Social Democrats to announce the general guarantee of banking deposits in Swedish banks on September 24, 1992. This announcement strengthened the coalition further in the hope of keeping the currency fixed.

Market instability continued until the presentation of "Crisis Package 2", only ten days after the first crisis package. This package aimed to improve the conditions for a fixed currency and entailed measures to improve the competitiveness of Swedish business. Important measures were, for example, an increase in VAT to finance lower payroll taxes – a so-called internal devaluation – and a withdrawal of the right to two extra vacation days decided upon in the spring of 1990.[45] These measures lowered the cost for Swedish business by about 4 percent.[46] The measures coincided with easing tensions within the ERM, and the Riksbank could gradually lower its interest rates to 11.5 percent by the

[40] Hamilton and Stuart, "I stormens öga," 127-8.
[41] Ministry of Finance, "Regeringens proposition 2000/01:100, Bilaga 5," 18.
[42] Hinnfors and Pierre, "The Politics of Currency Crises in Sweden,": 109.
[43] Ministry of Finance, "Regeringens proposition 2000/01:100, Bilaga 5," 18.
[44] Hinnfors and Pierre, "The Politics of Currency Crises in Sweden,": 109.
[45] Hamilton and Stuart, "I stormens öga," 142.
[46] Ministry of Finance, "Regeringens proposition 2000/01:100, Bilaga 5," 19.

beginning of November.[47] With Crisis Package 2 presented, it seemed that Sweden was out of its bind.[48]

However, the relative calm on the currency market was only temporary. In mid-November, market interest rates increased again and the Swedish National Debt Office (*Riksgäldskontoret*) failed to complete an auction of Treasury bills due to poor economic forecasts.[49] While the outflow of krona increased again, the government followed the established procedure, laying out the plans for a third crisis package and trying to round up support from the Social Democrats for new austerity measures. This time, however, the Social Democrats refused to collaborate.[50] The Prime Minister and the Finance Minister presented a governmental crisis package at a morning press conference, but it was to no avail. The relentless currency outflow continued and worsened when the U.S. markets opened for the day. Later that day (at 2.28pm) the Riksbank announced the floating of the krona.[51] Without the political coalition uniting behind a new crisis package to fend off the onslaught on the currency, the government's arsenal was empty. Hiking interest rates was out of the question, because it would only further worsen the financial crisis and economic recession, and the currency reserves faced rapid depletion. The government conceded defeat and finally adjusted its exchange-rate policy.

Although the financial crisis rallied the political elites in the effort to hold the fixed currency, the crisis package negotiations between the government and the Social Democrats finally became too much for the opposition. According to Stern and Sundelius, it was painful for the leadership of the Social Democratic Party (SAP) to endorse the measures. They risked cutting themselves off from a variety of factions within the party, such as the powerful labour unions, and they suffered harsh internal criticism for both the content and the process that produced the package.[52] Ingvar Carlsson, the leader of the SAP, confirms the party's internal decision-making problems:

> Since the decisions during the crisis negotiation had to be made so quickly, there was no opportunity to consult the members of the party, or to consider the viewpoints of the voters. Instead, the task became to explain and defend after the fact, when the decisions had already been made.[53]

The political mobilization turned out to be insufficient to convince the financial market of the merits of the fixed currency.

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[47] Ibid.
[48] Wibble, *Två cigg och en kopp kaffe*, 33.
[49] Ministry of Finance, "Regeringens proposition 2000/01:100, Bilaga 5," 19.
[50] Carlsson, *Så tänkte jag*, 502.
[51] Hamilton and Stuart, "I stormens öga," 164.
[52] Stern and Sundelius, "Sweden's Twin Monetary Crises of 1992,": 36-37, 41.
[53] Quoted in Teorell, "Demokrati eller fåtalsvälde?", 168. My translation.

Overall, this key decision of building a political coalition in response to the financial crisis shows both that there is interaction between politicians and the financial market and that policymakers can influence and shape the financial situation. Even in the worst of circumstances, policymakers can have at least a short-term impact on the financial market. However, there is always a price to pay for extreme policies, and it is up to the policymakers to decide over what issue and at what time it is right to pay that price.

This section has analysed three key decisions in the government's response to the financial crisis. These decisions were not part of an integrated and pre-planned approach to the crisis, but rather separable, ad-hoc measures in the government's crisis management effort. In retrospect, it is easy to conclude that the response of the state was too little, too late. Although the government and opposition joined forces in an all-out attempt of winning the respect of the financial market, they could only postpone the seemingly inevitable forces of the market. The next section relates these decisions to the established theoretical approaches outlined in chapter two.

5.3. Theories and the key decisions responding to the financial crisis

After analysing the key decisions in the state's response to the financial crisis, this section will focus on these decisions in relation to the conventional theoretical perspectives on the impact of globalization on the state. In what respects did the key decisions conform to any of these theoretical perspectives?

The powerless state approach

The first theoretical perspective was that of the powerless state. As elaborated in chapter two, globalists or hyperglobalists, such as Ohmae and Strange, view globalization as having such a pervasive impact on the state that it is rendered powerless.[54] The weakening state must adapt to the structural forces of globalization with no ability to shape the situation. In relation to the Swedish financial crisis, Hinnfors and Pierre make a similar point when they claim that "market actors appeared to have become not only the main constituents of public policy, but also the architects of those policies."[55] However, in the key decisions responding to the financial crisis, the Swedish government had different alternatives to pursue and could have structured its response to the crisis in a multitude of ways and to different effects. The response of the Swedish authorities mattered.

The first key decision, to support the banks and to set up the Bank Support Authority, certainly did not indicate any signs of powerlessness. This measure

[54] See, for example, Ohmae, *The End of the Nation State;* Strange, *The Retreat of the State*.
[55] Hinnfors and Pierre, "The Politics of Currency Crises in Sweden,": 110.

both stabilized and restructured the banking sector and bought politicians time to continue managing the crisis. Obviously, Sweden was in a bind and had to do whatever it could to improve the situation, but this is not the same as being powerless.

The second key decision was to defend the currency. Since the Riksbank finally had to let the krona float, the example seems to suggest that the Swedish state was powerless. However, the Swedish government made the active choice to defend the currency, while other states, such as Finland and the UK, made the opposite choice of letting their currencies float or realign. In doing so, they measured the opponent they faced and the cost entailed in fending it off, and decided that it was not worth the price. Indeed, the Swedish government had the same opportunity to change its exchange rate regime, but decided against this obvious alternative.[56] Therefore, the powerlessness of the state seems to be self-inflicted, from a misperception of the situation. The government underestimated the aggregated strength of the financial market actors, the strength of the Swedish economy, and the price for defending the currency. It was its zealous conviction about the importance of holding on to the fixed exchange rate, rather than the actual situation, that caused the refusal to consider the policy alternatives and instilled a sense of powerlessness among the policymakers when the krona finally had to float. Hence, it seems that hubris rather the powerlessness characterized the Swedish decision to defend the krona against all odds.

The third key decision was to build a broad political coalition to back the crisis measures and strengthen both the internal and external confidence in the Swedish economy. There were clearly many alternatives to this measure, but both the government and the opposition seem to have realized the importance of presenting a united proposal to deal with the dangerous situation. They also managed to stave off a number of attacks on the currency and buy time to launch a number of measures aimed at restructuring severe imbalances in the economy.

Like most small countries, Sweden has adapted to changing circumstances within and beyond national borders many times before. This has happened more with a sense of vulnerability than a sense of powerlessness. In the financial crisis, the deteriorating situation forced Sweden to take action, but Sweden had degrees of freedom in shaping its countermeasures regarding both time and content. The Swedish response mattered and it influenced the situation. After all, the financial system, the banks, and the currency recovered. Therefore, Sweden was clearly not powerless. The powerless state perspective comes up short and cannot inform our understanding of what happened. Overall, the powerless state perspective is unsatisfactory in the case of the Swedish financial crisis.

[56] In the government, alternative exchange-rate regimes were considered, but not acted upon. Hamilton and Stuart, "I stormens öga," 117-20.

The sovereign state approach

The second theoretical perspective presented in chapter two was the sovereign state approach. Proponents of this perspective, 'ultra-sceptics' such as Krasner, argue that the impact of globalization on the state is insignificant and that the state continues its operation regardless of globalization. In relation to the Swedish financial crisis, this approach seems far-fetched, because the external problems in the financial crisis clearly emanated from the actions of global financial market actors. These actors, rather than other states, infringed upon Swedish sovereignty, and this would not fit the sovereign state approach. However, from this approach one could claim that it was business-as-usual for a country with a small, open economy, such as Sweden, to be dependent upon and vulnerable to the workings of the international economy.

Two out of the three key decisions in the Swedish response to the financial crisis – supporting the banks and building a political coalition – indicate that there is still freedom of choice for the sovereign state. These findings seem to support the sovereign state approach. The sovereign state still directs its own destiny.

However, the actual decisions and measures in response to the crisis clearly show that the policymakers were aware of the growth of global finance, the importance of non-state actors and the importance for a small country to keep up the confidence in its open economy at home and abroad. Therefore, it seems unjustified to claim that globalization was insignificant and that it was business as usual for the state in this case. Furthermore, in the failed attempt to defend the krona, the impact of globalization and forces other than the state undermined the freedom of choice for the sovereign state. When it really mattered to the policymakers, the state could not impose its will on elusive traders on the financial markets. The financial markets vetoed Swedish policy, and the logic of the state had to bow to the logic of the market.

Possibly, this theoretical perspective influenced policymakers too much in their fixation on a fixed currency. They forgot to be pragmatic about power, to be open about who can wield it, and to nurture the capabilities of the state. Instead, they exaggerated the strength and importance of (sovereign) states, and underestimated the importance of non-state actors and the dynamics and effects of globalization. Overall, the sovereign state perspective fails to inform our understanding of the responses to the financial crisis.

The forced state adaptation approach

The third theoretical approach to the impact of globalization on the state is that of forced state adaptation. Proponents of this approach, such as Cerny, claim that the welfare state inevitably turns into a competition state due to unleashed global forces.[57] In relation to the Swedish financial crisis, Ryner makes a similar argument when he claims that:

> Globalisation of finance implied that it became impossible to politically control both the exchange and interest rate, since creditors always would have the option of 'exiting' from debt denominated in Swedish crowns. This made it exceedingly difficult for the state to continue to navigate between the Scylla of unemployment and Charbydis [sic] of wage drift, inflation and insufficient transformation pressure.…in the first part of the 1990s, Swedish policy-makers navigated into the arms of both monsters.[58]

The key decisions in response to the Swedish financial crisis fit to some extent with this perspective. The decisions to support the banks and to build a political coalition and launch austerity measures to please the financial market are obvious examples of measures where the market took primacy over the state. The state had to adapt to global forces and had only very limited scope of adaptation. The financial market had gained such influence that it could overturn regular political processes and demand implementation of specific measures.[59]

However, that demand was always open to the policymakers' interpretation. From this perspective, the decision to defend the krona would be seen as a last desperate attempt of the state to wield some power over the markets and the ultimate failure of the defence was actually the last sigh of the welfare state. The state was forced to adapt. However, this perspective exaggerates the impact of globalization and underestimates the choices available to the state. The problems in the banks were due to failed control and proactive restructuring of the banks as they faced to challenges of financial globalization. The problems stemmed from both the domestic situation and global forces. The limited choice in response to the crisis was due more to the depth of the crisis and late management effort of the crisis than the financial market forcing the state to adapt in a certain direction. Policymakers followed a steep learning curve to operate in the changing environment and the population had to pay their tuition.[60] As the crisis abated, choice increased again, and the Swedish welfare state seems alive and well.[61] The idea of a competition state has yet to materialize in Sweden. Overall, the forced state adaptation approach partially informs our under-

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[57] See, for example, Cerny, "Paradoxes of the Competition State,"."

[58] Magnus Ryner, *Capitalist Restructuring, Globalisation and the Third Way: Lessons from the Swedish Model* (London: Routledge, 2002), 110.

[59] Hinnfors and Pierre, "The Politics of Currency Crises in Sweden,": 110.

[60] On learning in crisis decision-making, see Stern and Sundelius, "Sweden's Twin Monetary Crises of 1992,".

[61] Duane Swank, "Withering Welfare? Globalisation, Political Economic Institutions, and Contemporary Welfare States," in *States in the Global Economy: Bringing Domestic Institutions Back In*, ed. Linda Weiss (Cambridge: Cambridge University Press, 2003), 69-70.

standing of the responses to the Swedish financial crisis, but its conclusion is too deterministic and has too extreme a view of the limits on the state's choices.

The policy choice approach

The last of the established theoretical perspectives on the impact of the globalization on the state is the policy choice approach. Proponents of this perspective, such as Garrett, argue that the state still has policy choice and that globalization only has limited impact on this choice.[62] In other words, globalization is significant, but not significant enough to force the state to adapt in a specific way. The government still has instruments at its disposal to respond decisively to the effects of globalization. In relation to Sweden, Swank makes a similar argument when he claims that "globalization (and other forces) have not produced much if any convergence of the Swedish welfare state with its neoliberal counterparts."[63]

Two of the three key decisions in the Swedish response to the financial crisis fit quite well with this approach. The decision to support the banks indicates that the state still can make a difference and both halt and turn around a disastrous development. There were different alternatives in supporting the suffering banks, and globalization had an impact on these alternatives. Yet, even heading towards the brink of disaster, Swedish policymakers had the nerve and ability to build a strong and broad enough coalition to launch and implement the measures to manage the crisis. However, in the case of the defence of the krona, the preferred choice was overturned, which makes the policy choice approach problematic. Policymakers were clearly constrained by the financial market reaction to the imbalances in the Swedish economy, and financial market realities trumped political choices. Nevertheless, the policymakers could have chosen to return to a fixed currency situation only a few years after the crisis. In that respect, the thwarted choice lasted during a limited period and under very specific circumstances.

Overall, the policy choice approach is the best of the conventional perspectives and improves our understanding of the state response to the financial crisis to quite a large extent. However, it still exaggerates the available choice and underestimates the significance and constraints imposed by globalization.

Ultimately, none of the conventional theoretical approaches is completely satisfactory in improving our understanding of the Swedish policy response to the financial crisis. The next section will relate the key choices to the constrained choice approach suggested in chapter two.

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[62] See, for example, Garrett, "Global Markets and National Politics,"; Geoffrey Garrett, "Shrinking the State? Globalization and National Autonomy in the OECD," *Oxford Development Studies* 26, no. 1 (1998).

[63] Duane Swank, *Global Capital, Political Institutions, and Policy Change in Developed Welfare States* (Cambridge: Cambridge University Press, 2002), 142.

5.4. Constrained choice and the key decisions in response to the financial crisis

The previous sections have shown that established theoretical approaches to the impact of globalization on the state do not satisfactorily explain what happened during the Swedish financial crisis of 1992. Therefore, these approaches are either flawed in varying degrees or they deal with the impact of globalization on the state at such a general level that they cannot explain particular empirical cases.[64] Some aspects of the Swedish financial crisis can be explained partially by some of the established theoretical approaches, but none of the approaches sufficiently covers the full complexity of all of the events that made up the crisis. An approach that improves both our understanding of the relationship between the impact of globalization on the state and what happened in the case of the Swedish financial crisis seems to be lacking. This section, therefore, presents a constrained choice approach focusing on how it relates to the identified key decisions of the Swedish government in response to the financial crisis.

A constrained choice approach is located between the state adaptation approach and the policy choice approach outlined in chapter two and elaborated upon in relation to the Swedish financial crisis above. As in the state adaptation approach, the constrained choice approach recognizes that the state also has to adapt to globalization, but not necessarily in a streamlined deterministic fashion towards the so-called 'competition state'. Rather, the pressures of globalization are not constant, and the state still has the ability to influence its circumstances and the direction of this adaptation. In relation to the Swedish financial crisis, Ryner makes this point when he claims that "Swedish policy-makers could have mitigated the power that global financial markets had on Swedish interest rates through a proactive state policy of foreign borrowing."[65] The extent of policymakers' influence varies depending on such factors as the characteristics of the country; the issue; public opinion; the choices, skills and priorities among domestic policymakers; and the actions and interests of external actors.

However, the rise of globalization has constrained policy choice to a greater extent than the policy choice approach admits. These constraints are of a

[64] For example, Lukauskas makes the argument that much recent research on global finance is underspecified regarding "which private or state actors are central to financial policy making, what their preferences are with respect to key issues, and what policy choices they face." Arvid Lukauskas, "Managing Mobile Capital: Recent Scholarship on the Political Economy of International Finance," *Review of International Political Economy* 6, no. 2 (1999): 283.

[65] Ryner, *Capitalist Restructuring*, 112.

material and ideational nature.[66] The material constraints are, for example, the vast stocks of capital available and its rapid flow on deregulated global financial markets. As shown in chapter three, the ease with which massive amounts of capital move around the world has increased substantially over the last decades. Mobile capital imposes a material constraint on state policies because the domestic economic situation can shift immediately when capital suddenly moves to other locations. Domestic interest rates, exchange rates, current accounts, etc. adapt in accordance with supply and demand on the global financial market and may quickly shift the economic foundation of policies. When the economic foundation of policies shifts, so does the political base.

Ideational constraints relate to the pressures on policymakers from the rise of supraterritoriality. Supraterritoriality forces them to make choices in financial policy faster and with more serious consequences. As Adler puts it, "the environment does not 'instruct' policymakers, it challenges them."[67] When there is less time for assessment of the specific situation, preconceived ideas and ideologically informed assumptions will influence decisions to an even greater extent than previously. Policymakers know that the financial market will interpret and assess their political and economic statements almost instantaneously.[68] The power of the capitalist discourse disciplines policymakers' thoughts and perspectives, and hence constrains the options considered.[69] Supraterritoriality has also made policy consequences harder to assess and foresee, because supraterritoriality has made the relationship between cause and effect even more complex. The same policy can be interpreted differently at different times on global financial markets and have very different consequences depending on how it is perceived. As access to information has increased tremendously, the interpretation of how others will perceive information is crucial in order to act before everyone else. Both material and ideational constraints limit the policy choices available to the state as the consequences on global financial markets must be taken into consideration. These constraints will be elaborated upon further in the next chapter.

An important consequence of the increasing constraints on policy choice is that the stakes for the state in pursuing autonomous policies have increased.

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66 See Colin Hay and Ben Rosamond, "Globalization, European Integration and the Discursive Construction of Economic Imperatives," *Journal of European Public Policy* 9, no. 2 (2002).

67 Emanuel Adler, "Cognitive Evolution: A Dynamic Approach for the Study of International Relations and Their Progress," in *Progress in Postwar International Relations*, ed. Emanuel Adler and Beverly Crawford (New York, NY: Columbia University Press, 1991), 53.

68 Jonung, "Den finansiella marknaden och demokratin i Sverige," 67.

69 Jon Pierre, *Marknaden som politisk aktör: Politik och finansmarknad i 1990-talets Sverige [The Market as a Political Actor: Politics and Financial Market in Sweden in the 1990s]*, Demokratiutredningens forskarvolym 11, SOU 1999:131 (Stockholm: Fakta Info Direkt, 1999), 45-51.

The rise of supraterritorial forces has given external actors and phenomena the opportunity to veto domestic policy choices regarded as unattractive by severely punishing their implementation. Punishment can be both swift and severe, as shown in, for example, the failed defence of the krona. The possibility of swift and severe punishment increases the stakes for state policymaking. The constraints on policy have diminished the margin of error for policymakers; they have to assess the risks emanating from the policy before making decisions. As the remaining policy choices have narrowed, it has become increasingly important to protect and nurture this policy space in order to retain future options.

The constrained choice approach suggests that, despite the considerable impact of globalization, the state still has policy choice available to it, although it is a constrained choice. Globalization has limited policy choices for the state, but it does not deterministically force the state's hand. In other words, globalization has narrowed the bandwidth of choice for the state, but there is still choice within this remaining policy space. As Kurzer put it in relation to Sweden in the early 1990s, "the world economy started to intrude on the policymaking sphere."[70] Supraterritorial relations have crowded out some of the policy space previously available for state policymaking.

The constraints on policy are not equal for all states. Rather, the degree of constraints varies among states. Large advanced industrial states, such as the U.S., have more policy choice than poor developing countries. Broz and Frieden, for example, argue that "national policy choices, especially of large countries, have a powerful impact on the nature of the international monetary system."[71] However, even the great powers face tighter limits on their policy choice in the global economy. Katzenstein points out that "'rule taking' rather than 'rule making' is becoming increasingly important"[72] for the great powers. Thus, states have become more constrained, but the degree of constraints varies between countries and over time.

Therefore, the growth and effects of supraterritorial relations is a dimension that is increasingly important to consider in the formation of state policies. The supraterritorial characteristics make it problematic for most states to shape these relations alone. The shaping of supraterritorial relations according to the wishes of the state would demand coordination with other states to have a potential impact. An example of this during the Swedish financial crisis is the government's approaching of the British Chancellor Norman Lamont, who chaired Ecofin (Council of Economic and Finance Ministers), and Hans Tietmayer, President of the German Bundesbank, probing the future entry for the krona

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[70] Paulette Kurzer, *Business and Banking: Political Change and Economic Integration in Western Europe* (Ithaca, NY: Cornell University Press, 1993), 191.
[71] Lawrence J. Broz and Jeffry A. Frieden, "The Political Economy of International Monetary Relations," *Annual Review of Political Science* 4, no. 1 (2001): 318.
[72] Katzenstein, *Small States in World Markets*, 22.

into the EMS (European Monetary System).[73] The government had unilaterally committed to the fixed exchange rate and it wanted external backing for the currency through the reciprocal commitment institutionalized within the EMS to gain credibility for the fixed krona. However, before the coordination to shape supraterritorial relations is established, the state has to find its own way of effectively dealing with the development. Thus, globalization has forced states to adapt by narrowing the bandwidth of policy choices available to them. This adaptation has taken place to the extent that 'extreme' choices are now outside the narrowed bandwidth of policy choices. These choices are either unfeasible or too expensive to implement. State policy thus operates within tighter constraints; in other words, the states' policy space has narrowed as a result of supraterritorial relations.

The options available to the state have always had limitations. The constraints on policymakers come from below (from those they represent), from above (from the system wherein they operate), and from within (from their personal abilities and characteristics). These constraints interact and shape the options available to the policymaker. In this account, the focus is on the constraints coming from the system and more specifically from the growth of supraterritoriality. Thus, supraterritoriality only constitutes an additional constraint among others, although it is of increasing importance. Traditionally in International Relations, the external constraints on state decision-making were primarily ascribed to other states, but the increase in supraterritoriality has empowered non-state actors and diversified and increased the external constraints exerted on the state. For example, financial markets can under specific circumstances discredit or veto governmental policies and this market reaction can in turn force governments to adapt their policies.[74] This realization itself works as a constraint on policy that influences democracy and state autonomy. Sinclair, for example, argues that the *potential* of capital mobility has a larger impact on social practices than the actual flows of capital.[75] Both the potential and actual aspects of supraterritoriality have limited democracy and state autonomy. The challenge for the government is not only to be re-elected, but also to avoid having its policies overturned by external actors and events. Therefore, supraterritoriality constitutes a check on policy that influences and constrains state decision-making and available choices. There were boundaries before, but they were to a large extent domestically set. The rise of supraterritoriality is another important variable for the state to consider in policymaking. Thus, globalization, and especially the feature of capital mobility, has further constrained the boundaries for policy choice.

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[73] Hamilton and Stuart, "I stormens öga," 105-6.
[74] Cohen, *The Geography of Money*, 133.
[75] Sinclair, "International Capital Mobility," 95.

How does the constrained choice approach relate to the previously identified key decisions in the Swedish response to the financial crisis? In the decision to support the banks, the government had to secure the payment system and uphold the confidence in the banks to avoid a bank run and the Swedish economy grinding to a halt. In its inability to restructure the banking sector proactively, the government saw its policy space narrow as the banking sector neared the brink of disaster. At the brink, however, there was still space to shape the design, targeting, and timing of bank support. The pressures of the global financial markets increased the urgency of the bank support and the importance of widely communicating the support to the actors in the financial market, but it did not completely preclude choice. Policy choice was constrained, but sufficient to influence the outcome of the financial crisis.

In making the decision to defend the krona, the government, backed by the opposition, believed that its available policy space was much broader than it was in reality. While a variety of policy alternatives were available to it, it chose an alternative that was outside the bounds of its policy space, in the constrained choice environment in which it was operating. Its lack of understanding of and sensitivity to the pressures of the global financial markets made it possible for the government to believe that it could successfully defend the fixed exchange rate and counter the financial market pressures without devaluation of the krona. The government resolutely defended its policy space on this particular issue, but finally pushed the financial markets to impeach the policy by providing the opportunity for speculators to exploit the overvalued currency and drain the Swedish reserves. Arguably, the government's intense focus on the defence of the krona diminished its ability to defend its policy space in other areas by worsening Sweden's already weak economic position. The government had months to back down and could have followed both the Finnish and British central banks' decisions to either realign or float the currency. By not recognizing the constraints on its policy space, the government chose to challenge the market head on and was taught the hard lesson that globalization matters, that the environment had changed, and that actors on the global financial markets could overturn governmental policy under specific circumstances. In traditional national security matters, Sweden refined its pragmatism over the years and would never have challenged the Soviet Union or anyone else. Nurturing and defending the government's policy space took primacy to principles of right and wrong. However, in relation to the financial markets, while suffering a severe financial crisis, Sweden was willing to take a gamble. This was an ideational constraint among the key policymakers, and their extreme position became very costly. As argued in chapter four, having to float the currency was the turning point of the financial crisis.

In the key decision to build a political coalition to strengthen both internal and external confidence in the Swedish crisis management effort, the government and the opposition realized the importance of signalling unity and commitment to the effort in order to augment the faltering credibility of the Swedish financial system. The building of the political coalition was necessary to postpone the financial market overthrowing of governmental policy and thereby win some valuable time for improving the economic situation, and organization and implementation of the crisis management effort. It also brought important support to the suffering banks and reforms to the dysfunctional Swedish economy. In this case, the government and opposition jointly defended this policy choice, extended the time available to manage the crisis, and laid the foundation for recovery. Had the government not managed to bring the opposition into a coalition, it would probably not have fended off the financial market challenge for so long, but it also would have made the recovery more problematic. The self-imposed constraints on policy and the perception of crisis brought together the government and the opposition. The political coalition facilitated the reconstruction of the Swedish economy.

Overall, the constrained choice approach relates very well to the key choices of the Swedish government in response to the financial crisis of 1992. Drawing on the strengths and benefits of the established theoretical approaches, the constrained choice approach offers a more refined approach that improves our understanding of what happened in the Swedish financial crisis. The following two chapters will in turn further explore the global constraints imposed on policymakers and the policy options available to policymakers despite these global constraints.

Chapter 6: Global Constraints in the Swedish Financial Crisis

6.1. Introduction

While the global constraints that impose upon and circumscribe the state have been a major theme in the globalization literature, the concept of "global constraints" itself has been underdeveloped. The aim of this chapter is to identify and analyse the global constraints imposed on the Swedish state during the financial crisis. This chapter first elaborates on the general characteristics of global constraints on the state and then relates these constraints to the key decisions of the Swedish state during the financial crisis.

The previous chapter briefly analysed three key decisions during the Swedish financial crisis in relation to the different perspectives on the impact of globalization on the state. It found the four conventional approaches suggested in chapter two wanting and the constrained-choice approach promising. In order to further develop the constrained-choice approach, this chapter challenges the structure-oriented perspectives represented by the 'powerless state' and 'forced state adaptation' approaches. Therefore, this chapter takes the top-down perspective on the Swedish financial crisis, analysing the global constraints on Swedish state actors. The next chapter aims to develop the choice part of the constrained-choice approach and challenges the agency-oriented perspectives, i.e. the 'sovereign state' and 'policy-choice' approaches. In that chapter, the crisis will be analyzed from the bottom up and focus on state actors' capacity to act despite these constraints. Together these two chapters develop the constrained-choice approach with the aim to capture both sides of the ongoing dynamic between structure and agency that the conventional approaches miss.

It is common among approaches that focus on global constraints (i.e. the 'powerless state' and the 'forced state adaptation' approaches, according to the categorization made in this dissertation) to assert that, as a result of globalization, states have lost political autonomy, and face profound limitations on their policy choices and ability to promote prosperity and provide social protection. However, these analyses rarely specify the eras compared and provide only limited empirical evidence of the actual constraints. A typical argument from a constraint perspective is that the government's role now is restricted to providing the rule of law, basic regulation, and a minimum of social security. Beyond the theoretical logic of constraints asserted in most constraints perspectives, it is the aim of this chapter to provide empirical evidence of the global constraints that influenced policymakers during the Swedish financial crisis.

In general, policymakers face constraints on many levels and especially in times of crisis. This was the situation in the Swedish financial crisis as well, where constraints emanating from the individual level all the way to the systemic level had an impact on policymakers. Although internal and external constraints are closely interrelated and only artificially separable, for matters of exposition the focus in this study will be on constraints concerning the processes of globalization as defined in chapter two.

Global constraints are the externally imposed boundaries that limited Swedish policymakers' ability to act in the financial crisis. In other words, global constraints set the playing field within which Swedish policymakers had the freedom to pursue different actions. The internal domestic constraints, on the other hand, pushed policymakers in one direction or another within these bounds. The argument in the constrained-choice approach is that the playing field has narrowed due to processes of globalization and that there is now less room to manoeuvre for policymakers. However, the limitations on the state are not as severe as claimed in the constraint approaches. The state still has the capacity to influence its direction and destiny beyond the firm constraints proposed in the 'powerless state' and 'forced state adaptation' approaches.

As one of many actors in an interconnected system, that state can push but never go beyond the boundaries of the system whereof it is an integral part. The capacity to push or influence the boundaries of the system varies among actors and over time. In that respect, the workings and order of the system always impact upon the policy options of the state to some extent. The processes of globalization, and especially increasing capital mobility, have transformed and added new dimensions to the system. As Andrews argues, "Capital mobility constitutes a structural feature of international affairs inasmuch as the degree of mobility systematically alters state calculations and behaviour."[1] However, the impact of global constraints on the state varies over time and according to circumstances. Just as states are not static entities, neither is the impact of global constraints constant. The magnitude of global constraints on the state depends upon the conjunction of a number of factors and processes that are both external and internal to the state, i.e. the vulnerability of the state to global constraints depend both on domestic institutions, actors, and priorities, and global actors and order. Therefore, the environment may allow certain actions at one point, but disallow the same actions at another. [2] In this respect, global constraints on the state are inherent features of the system that materialize only when certain eventualities coincide in time.

The financial crisis is a typical example of a situation where the regular trade-offs and conflicting interests of policymakers also encounter global constraints. The domestic financial crisis attracts global attention, because, on the

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[1] Andrews, "Capital Mobility and State Autonomy,": 202.
[2] Mosley, *Global Capital and National Governments*, 310-1.

one hand, the globalization of financial markets and the dependence of modern economies on functioning financial markets have made everyone stakeholders in financial stability, and, on the other, the usually sharp volatility during financial crises offer great potential for speculation and profit. In the usually chaotic context of a financial crisis, the risk level increases and domestic and global financial market actors train their eyes on the unfolding development of the crisis. In this situation, financial market actors scrutinize a larger sample of policies that goes beyond the usual key macroeconomic indicators in search of first-mover advantage. As the financial crisis worsens and the market threatens to collapse, the timing of the exit determines the success or failure of financial market actors. As their attention turns from the big picture to the details, policies that market actors usually would disregard suddenly become interesting. Mosely, for example, points out that "where default risk is essentially nonexistent, market participants can exclude many types of indicators from consideration; on the other hand, where default risk is highly salient, investors have material incentives to consider a wide range of information."[3] As argued in chapter four, the Swedish financial crisis took shape over a longer period, and the specific timing and depth of the crisis depended on the confluence of long-term and short-term events. A financial crisis is a situation when global constraints are at their most obvious and the Swedish financial crisis is a case in point.

Since the leverage of global constraints varies over time and circumstance, any analysis of them can only be a snapshot of a specific point in time. In order to capture the global constraints in the Swedish financial crisis, this chapter will base its evaluation of global constraints both on written accounts of and elite interviews with actors involved in the crisis. However, there is a methodological difficulty in capturing the global constraints based on their accounts. Politicians easily become "prisoners of administration."[4] Operators in the midst of a crisis tend to focus on practicalities and do what they can, rather than dwell on what they cannot do. Most actors involved would not assess the structural and environmental constraints they faced, but try to work out the day to day practicalities of the crisis. The identified global constraints are therefore indirect and subsequent constructions of what transpired. With this caveat in mind, the focus will be on the perceptions of global constraints that policymakers faced.

The organization of this chapter is as follows. The next section identifies constraints imposed by globalization on the Swedish state at the time of the financial crisis and the following section relates the identified constraints to the key decisions in the Swedish financial crisis and evaluates what, if any, constraints were significant to this specific case.

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[3] Ibid., 306.

[4] Olle Wästberg, *Det tomma rummet: Om politikens vanmakt [The Empty Room: On the Powerlessness of Politics]* (Stockholm: Wahlström & Widstrand, 1996). My translation.

6.2. Characteristics of global constraints

A common theme in studies of globalization, particularly when the focus is on financial issues, is that global dynamics and forces constrain the state. It is often argued that processes of globalization have changed the environment or system within which states operate and thereby reduced the policymaking capacity of states and constrained the options available for state policy. A prevalent argument among theorists dealing with constraints on the state due to globalization relates to economic openness, an integral part of globalization.[5] The argument is that economic openness has made certain national policies unviable and inefficient. As barriers to trade and financial flows have come down or disappeared and governments have signed international agreements institutionalizing this effect, the openness restricts the scope for governmental action. Thus, globalization has changed the environment, constrained the traditional sphere of governance for the state, and forced the state to adapt. This is a top-down approach that focuses on the structural pressure on the state induced by the processes of globalization.

The purpose of this section is to discuss the general characteristics of the global constraints that potentially had an impact upon Swedish policymakers' decisions in the financial crisis of the early 1990s. Global constraints are generally categorized as either of material or ideational nature.[6] The material constraints usually derive from systemic changes, resources, and institutional processes and practices, whereas ideational constraints emanate from ideas and awareness. On their own or in some combination, material and ideational constraints make up the structural pressures of globalization on the state.

Before elaborating further on these constraints, it is important to understand the mechanisms that make these constraints operative. Global constraints influence state policy options through three mechanisms founded on economic openness. They are the logic of exit, the logic of entry and systemic pressure. With regard to finance, the capital mobility hypothesis is probably the strongest expression of the logic of exit and the constraints that globalization has imposed on the state.[7] The capital mobility hypothesis proposes that "when capital is highly mobile across international borders, the sustainable macroeconomic policy options available to states are systematically circumscribed."[8] The costs involved in pursuing monetary independence have made it unfeasible, if not im-

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[5] Linda Weiss, "Introduction: Bringing Domestic Institutions Back In," in *States in the Global Economy: Bringing Domestic Institutions Back In*, ed. Linda Weiss (Cambridge: Cambridge University Press, 2003), 2.

[6] Hay and Rosamond, "Globalization, European Integration and the Discursive Construction of Economic Imperatives,": 147-51.

[7] Kenneth P. Thomas and Timothy J. Sinclair, "Structure and Agency in International Capital Mobility: An Introduction," in *Structure and Agency in International Capital Mobility*, ed. Timothy J. Sinclair and Kenneth P. Thomas (Basingstoke: Palgrave, 2001), 3.

[8] Andrews, "Capital Mobility and State Autonomy,": 193.

possible, to attain. The capital mobility hypothesis rests on Hirschman's logic of exit, voice and loyalty.[9]

On a deregulated capital market, it is easy for capital to move to a location offering better returns. When investors can exit, they gain voice in shaping governmental policies according to their priorities and the government cannot count on their loyalty. The consequence is increasing political leverage for firms and investors. As Cohen points out,

> Financial globalization gives selected societal actors a de facto veto power, elusive but effective, over state behavior. It is elusive because it is exercised indirectly, through market processes rather than formal lobbying. Policy autonomy is threatened, but not in a purposive or hostile way. The veto is effective because it involves a menace, the risk of exit, that may never be implemented but is forever present.[10]

Connected with the capital mobility hypothesis and the logic of exit, is another constraining mechanism – the logic of entry that can trigger a so-called race to the bottom.[11] This is an extension of the logic of exit. When capital exits one market, it enters another. Governments are engaged in a competitive race to attract capital. This has led governments to underbid each other in order to increase the amount of external capital entering the domestic economy and retaining already invested capital in the country. Governments have used subsidies, tax breaks, regulations etc. to make the domestic economy more attractive to mobile capital. This mechanism is arguably one reason behind the widespread trend of market deregulation since the 1980s.[12] It has also given external actors, such as transnational companies and financial investors, leverage over policy.

A third mechanism constraining state policy in the global economy is the systemic pressure of global financial markets.[13] Increasing capital mobility has made the financial markets more volatile and interconnectedness allows this volatility to spread rapidly within the system. Financial crisis has become contagious.[14] The systemic risks posed by volatile global financial markets have direct political repercussions. Going against the general trend under these circumstances threatens to draw attention from the global financial markets and may

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[9] Albert O. Hirschman, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge, MA: Harvard University Press, 1970).
[10] Cohen, *The Geography of Money*, 133.
[11] For a good discussion, see Spar and Yoffie, "A Race to the Bottom or Governance from the Top,".
[12] Eric Helleiner, "Freeing Money: Why Have States Been More Willing to Liberalize Capital Controls than Trade Barriers," *Policy Sciences* 27, no. 4 (1994): 300-3.
[13] Stephany Griffith-Jones, *Systemic Risk and Financial Crisis: How Can Future Currency Crises Be Prevented or Better Managed?* (Stockholm: SIDA, 1996), A Report from the Economic Analysis Unit, 4/96.
[14] Kindleberger, *Manias, Panics, and Crashes*, ch. 8.

trigger capital flight. It is not prudent to upset the market and the actors adapt accordingly. The government has to take the global perception of and potential reaction to domestic policies into consideration when making policy.[15]

Although these mechanisms are theoretically and logically coherent, they have been questioned on empirical grounds. For example, capital is not as mobile as supposed in the capital mobility hypothesis[16], there is only limited evidence of a race to the bottom[17], and systemic pressures are neither of constant nor always of primary importance in policymaking.[18] Keeping these critical points about these mechanisms in mind, the point here is to what extent different global constraints influenced Swedish policymakers during the financial crisis. This influence depends on the material and ideational constraints that faced Swedish policymakers. Before relating the global constraints to the Swedish financial crisis specifically, the discussion below elaborates on the global material and ideational constraints imposed on states operating on the global financial market.

Global material constraints

The development of the global financial system and behaviour of the global financial market constitutes a global material constraint on the state. As argued in chapter three, the previously international financial market has expanded and transformed into a truly global marketplace over the last couple of decades. According to Underhill:

> The metamorphosis of a series of closed, cartelised, nationally controlled and often segmented financial systems into a transnationally desegmented and marketised space characterised by a high degree of capital volatility and mobility is one of the great and unplanned transformations of the twentieth century.[19]

The quantitative and qualitative changes have gone far enough to call it a global financial system. In the so-called "financial services revolution"[20], the deregulation of capital controls, new technologies, and financial innovation have facili-

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[15] Hinnfors and Pierre, "The Politics of Currency Crises in Sweden,": 116.

[16] See, for example, Sinclair, "International Capital Mobility,"; Weiss, *The Myth of the Powerless State*, 178-84.

[17] See, for example, Garrett, "Global Markets and National Politics,"; Spar and Yoffie, "A Race to the Bottom or Governance from the Top,".

[18] See, for example, Mosley, *Global Capital and National Governments*.

[19] Geoffrey R. D. Underhill, "Private Markets and Public Responsibility in a Global System: Conflict and Co-operation in Transnational Banking and Securities Regulation," in *The New World Order in International Finance*, ed. Geoffrey R. D. Underhill (Basingstoke: Macmillan, 1997), 42.

[20] Michael Moran, *The Politics of the Financial Services Revolution: The USA, UK and Japan* (Basingstoke: Macmillan Press, 1991), 9-10.

tated increasing cross-border capital flows and financial openness. Of course, deregulation is something of a misnomer. As Cerny argues, the deregulation process has not meant the abolition of rules and regulations, but rather that it has been a process of re-regulation in a market-oriented direction.[21] As a result, states are intensively engaged in global financial activity and they have consequently become more dependent on a functioning financial system for the operation of their national economies, whether it regards servicing debt or raising capital for investment.[22]

The increasing dependence on and exposure to global financial market have provided great economic opportunities for some actors, but also made states more susceptible and therefore vulnerable to phenomena transmitted through financial channels. The frequency of financial crises has doubled since the Bretton Woods system and is now as bad as during the Great Depression.[23] With deregulation and increasing capital mobility, the state always runs the latent risk of a sudden shift in capital flows. When financial actors operate with the same information and make similar interpretations of how everyone else will react upon this information, they start acting like a herd and this makes the financial market highly volatile.[24] For example, when financial market actors lose confidence in an asset or country's economy, it can rapidly make the currency, bond, or stock worthless as the market suffers a sever loss of liquidity because everyone changes opinion simultaneously. A related problem and phenomena is that of contagion. In the global financial system, financial crisis has spread from one country to another without any clear connection to the initial problem. For example, the fall of Finland's currency in August 1992 was contagious in that it subsequently triggered a speculative attack on the Swedish currency.[25] Therefore, global financial markets tend to be volatile and to overshoot, i.e. overreact to information. As Krugman points out,

> Because speculative attacks can be self-justifying, following an economic policy that makes sense in terms of the fundamentals is not enough to assure market confidence. In fact, the need to win that confidence can actually prevent a country from following otherwise sensible policies and force it to follow policies that otherwise would seem perverse.[26]

In the Swedish case, this confidence aspect was particularly obvious in the defence of the currency in the fall of 1992.

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[21] Cerny, "The Deregulation and Re-Regulation of Financial Markets," 52.

[22] See, for example, Gilpin, *Global Political Economy*, ch. 10; Held and others, *Global Transformations*, ch. 4.

[23] Bordo and others, "Is the Crisis Problem Growing More Severe?,".

[24] Eatwell and Taylor, *Global Finance at Risk: The Case for International Regulation*, 111.

[25] Eichengreen, *Capital Flows and Crises*, 157, 159.

[26] Krugman, *The Return of Depression Economics*, 113.

While the global financial system shapes behaviour, however, it does not necessarily control it. As Jervis points out, "the existence of system effects need not cripple human action. The fact that there is no straightforward way to reach one's goal does not mean that there is no way at all to reach it."[27] Thus, the behaviour of the global financial system imposes a global constraint on the state that varies depending on the situation, but it does not necessarily preclude state action and choice.

The dynamics and behaviour of the global financial markets also imposes more specific material global constraints on states by exacerbating the resource gap between the state and the financial market. The exponential growth of global finance over the last couple of decades has continuously widened the gap between resources available to the state and to the global financial market.[28] Capital flows respond quickly to changes in the expectations of financial market actors and this can make it costly and difficult for a government to pursue a preferred policy such as a fixed currency. The development of the global financial market has made the state resources inadequate to successfully challenge or counter the prevailing market sentiment. When a financial crisis looms, this resource gap widens further as risks, volatility, and profit opportunities attract the attention of a broader selection of financial market actors. As Kirshner argues, in a globalizing world economy "all states will be more like small states"[29] in the sense that they are more susceptible to and have less influence on external pressures. More states have to adjust and adapt to global economic forces, while fewer states have the capability to shape these forces.

In a deregulated financial market, it is obviously harder for the government to control and direct resources and it has less time to manage the flows.[30] When state action is continuously evaluated on the financial market the available resources become even more precious for the state, since new policies and sentiments suddenly can change market expectations. In the midst of financial crisis it is even more difficult for the state to mobilize capital fast enough to counter such sudden events in the market as a speculative attack. The options of spending the foreign exchange reserves, borrowing in global capital markets, raising interest rates to attract more capital, or depreciating the currency have profound consequences on policies and the overall economic situation.[31] Other measures, such as increasing revenue through taxation, cutting costs, or stock-

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[27] Jervis, *System Effects*, 260-1.

[28] Held and others, *Global Transformations*, ch.5.

[29] Jonathan Kirshner, "Political Economy in Security Studies After the Cold War," *Review of International Political Economy* 5, no. 1 (1998): 69.

[30] Michael C. Webb, "International Economic Structures, Government Interests, and International Coordination of Macroeconomic Adjustment Policies," *International Organization* 45, no. 3 (1991): 319.

[31] David Leblang and William Bernhard, "The Politics of Speculative Attack in Industrial Democracies," *International Organization* 54, no. 2 (2000): 291.

piling sufficient reserves in prosperous times, are both practically and politically difficult to implement. The political difficulties in developed welfare states to shed tasks once brought under their auspices further exaggerate the lack of resources for the state.[32]

Financial liberalization and the growth of global finance have raised the stakes and made state intervention riskier, less effective, and costlier, especially during a financial crisis. Together with the risk of capital flight, lack of resources has heightened the sense of vulnerability and therefore increased the constraints on policy. As Scholte argues, "even the best-endowed contemporary state does not have the means to assert *sovereign* control over global capitalist flows."[33] However, this does not mean that state intervention is impossible. States can still sometimes impede and outmanoeuvre financial market actors with decisive and well-timed intervention.[34]

In the Swedish case, the government intervened in the banking crisis and succeeded in containing the banking crisis and avoiding a financial collapse. Available resources turned out to be sufficient to restore credibility and stabilize the Swedish banking system. In the currency crisis, on the other hand, the government intervened on the market to hold the fixed currency. The reserves sufficed temporarily, but in the end the government had to give up the defence of the currency. Finite resources made it difficult, costly, and ultimately impossible for the Swedish government to pursue policies that deviated from the prevailing market opinion. Still, it is at least theoretically possible to go against the market if the state is willing to pay the price. As Pauly argues, "capital mobility constrains states, but not in an absolute sense. If a crisis increases their willingness to bear the consequences, states can still defy markets."[35] The widening gap of resources available to the state and on the global financial market is an important global material constraint on the state.

Another global material constraint on the state is the impact of global institutions. Intergovernmental institutions have both facilitated the process of globalization and become more important as a consequence of supraterritorialization. For example, organizations like the IMF and the World Bank have been promoters and enablers of market liberalization and thus facilitated the process of globalization.[36] At the same time, supraterritorial phenomena unleashed in

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[32] See Paul Pierson, "The New Politics of the Welfare State," *World Politics* 48, no. 2 (1996): 144-7.
[33] Scholte, "Global Capitalism and the State,": 445.
[34] Ibid.
[35] Louis W. Pauly, "Capital Mobility, State Autonomy and Political Legitimacy," *Journal of International Affairs* 48, no. 2 (1995): 373.
[36] Miles Kahler, *International Institutions and the Political Economy of Integration* (Washington, DC: The Brookings Institution, 1995), 49; Jonathan Kirshner, "The Inescapable Politics of Money," in *Monetary Orders: Ambiguous Economics, Ubiquitous Politics*, ed. Jonathan Kirshner (Ithaca, NY: Cornell University Press, 2003), 5.

the process of globalization have to be managed by suprastate authorities to be effective.[37]

There has been a tremendous growth of international agreements and organizations that also constrain state policies over the last couple of decades.[38] The treaties, codes of conduct, norms, and regulations that make up the so-called international financial architecture narrow the room to manoeuvre for the state and other actors by defining the playing field and rules of engagement. Within the institutional boundaries, however, there is freedom to act and institutions enable certain policies that would have been impossible without the institution. As Webb points out, "the future stability of the international economy depends heavily on the possibilities of macroeconomic policy coordination."[39] Global institutions provide important venues for policy coordination. However, the global financial market develops very quickly with new financial actors and instruments entering the market continuously. This means that financial regulation and surveillance always lag behind market development and that authorities have the daunting task to amend their regulations and procedures in order to keep up with market transformation and to check rising risk levels.

In promoting and enabling the process of globalization, global institutions have imposed a constraint on the state. In joining and adhering to global institutions, states have agreed to this type of constraint voluntarily or of necessity. The global institutional constraint could be imposed voluntarily on the state, if it, for example, prefers the advantages of cooperation and coordination in an issue area to the opposite. However, the global institutional constraint on the state can also be based on necessity. For example, the external pressure to participate can become too burdensome or the highly indebted developing country may have little choice but to adhere to the conditions for new loans from the IMF. Furthermore, established institutions can "assume a life of their own"[40] and develop in different directions. Once a state becomes a participant in a global institution, the cost of breaking out of it can significantly constrain the options available to the state. Enmeshment in collaborative and regulatory arrangements often precludes the option of exit.[41] There is always an institutional trade-off whereby a state wins some and loses some in adhering to an institu-

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[37] Scholte, *Globalization*, 143-4.
[38] Weiss, "Introduction: Bringing Domestic Institutions Back In," 8.
[39] Michael C. Webb, *The Political Economy of Policy Coordination: International Adjustment Since 1945* (Ithaca, NY: Cornell University Press, 1995), 258.
[40] Stephen D. Krasner, "Regimes and the Limits of Realism: Regimes as Autonomous Variables," in *International Regimes*, ed. Stephen D. Krasner (Ithaca, NY: Cornell University Press, 1983), 357.
[41] Mark W. Zacher, "The Decaying Pillars of the Westphalian Temple: Implications for International Order and Governance," in *Governance without Government: Order and Change in World Politics*, ed. James N. Rosenau and Ernst-Otto Czempiel (Cambridge: Cambridge University Press, 1992), 60.

tion, and this trade-off can change over time. Global institutions may levy an important material constraint on the state.

Just as global institutions may constrain states, the underdevelopment or lack of a global regulatory framework may let supraterritorial phenomena exert constraints on the state more or less unchecked. For example, it was the many financial crises of the 1990s that alerted global institutions like the BIS and IMF of the severe externalities of deregulated capital markets and triggered institutional development and adaptation to improve the so-called international financial architecture.[42] Where the state lacks the resources and the global regulatory framework is underdeveloped or insufficient to allow the state to effectively deal with supraterritorial constraints, regional integration and cooperation might increase state capacity to deal with processes of globalization. Thus, the trend towards regionalization can be seen as interconnected with and complementary to the processes of globalization. [43] For states, regionalization can be an intermediate or second-best alternative in managing supraterritorial problems, while lacking adequate global institutions. Without the global governance framework provided by global institutions, there is even less opportunity for smaller and less powerful states to change the system or de-legitimatize the actions of more powerful actors. For example, only very few, if any, individual states can change the financial system, but coordinated state action could transform the financial system and empower states to manage supraterritorial problems like those emanating from global financial markets.[44] Whether the global or regional institutional framework enables or constrains the state depends on the setting.

A serious problem for states lacking an effective global institutional framework is institutional inertia. Institutional development and design inevitably lag behind changes in the environment. Many important global and regional institutions were designed to deal with problems relating to a different time and setting, and they are often slow to adapt to new challenges.[45] Just as for states, it takes time for institutions to adapt. Slowly, international organizations, such as the IMF, the World Bank, the BIS and the OECD, adapt to new chal-

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[42] See, for example, Barry Eichengreen, "Governing Global Financial Markets: International Responses to the Hedge-Fund Problem," in *Governance in a Global Economy: Political Authority in Transition*, ed. Miles Kahler and David A. Lake (Princeton, NJ: Princeton University Press, 2003).

[43] Scholte, *Globalization*, 147. For the opposite perspective, see Colin Hay, "Contemporary Capitalism, Globalization, Regionalization and the Persistence of National Variation," *Review of International Studies* 26, no. 4 (2000).

[44] Webb, "International Economic Structures,": 313.

[45] Oran B. Young, "The Effectiveness of International Institutions: Hard Cases and Critical Variables," in *Governance without Government: Order and Change in World Politics*, ed. James N. Rosenau and Ernst-Otto Czempiel (Cambridge: Cambridge University Press, 1992), 202-6.

lenges and amend, expand, or reconcile their missions to new circumstances.[46] Unfortunately, institutional creation and adaptation tend to be driven by dramatic events, rather than proactive prevention of such events. For example, the Bretton Woods institutions, the IMF and the World Bank, were created in the aftermath of World War II and the Asian financial crisis served as a trigger of their institutional adaptation.

The regionalization trend has been one response from states to manage supraterritorial problems without effective global institutions. Deep integration has become a strategy adopted by states to cope with the processes of globalization.[47] As Moses et al. argue with regard to developments in Europe, "Globalization is concomitant with Europeanization because the forces which are affecting individual nation-states are, arguably, the same which are pushing European nation-states towards greater unity."[48] The lack of global institutions able to manage and alleviate the impact of global phenomena has accelerated efforts towards regional integration. To the extent that regionalization is a response to global forces, regional institutions are also a global material constraint imposed on the states.

During the Swedish financial crisis, the government wanted to confirm its adherence to a new low inflation norm and establish credibility and recognition of its policy shift away from devaluations and high inflation in order to qualify for EC membership. The urge to join and qualify for EC membership constrained and limited the available options for Swedish policymakers. The global and regional institutional framework constrains the policy options of states.

Global ideational constraints

Ideational processes are an integral part of globalization and as such they impose ideational constraints that both complement and augment the global material constraints on the state analysed above. Scholte, for example, argues that "globalization has occurred in part because of certain powerful patterns of social consciousness."[49] He argues that rationalism as the predominant social structure has subordinated other kinds of knowledge and furthered global thinking. When increasing capital mobility, in particular, changes the structure of the world economy, the interpretation of this change has a significant impact

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[46] See, for example, Vinod K. Aggarwal, "Reconciling Multiple Institutions: Bargaining, Linkages, and Nesting," in *Institutional Designs for a Complex World: Bargaining, Linkages and Nesting*, ed. Vinod K. Aggarwal (Ithaca, NY: Cornell University Press, 1998), 1.

[47] See Sylvia Ostry, "Convergence and Sovereignty: Policy Scope for Compromise?," in *Coping with Globalization*, ed. Aseem Prakash and Jeffrey A. Hart (London: Routledge, 2000).

[48] Jonathon W. Moses, Robert Geyer, and Christine Ingebritsen, "Introduction," in *Globalization, Europeanization and the End of Scandinavian Social Democracy?*, ed. Robert Geyer, Christine Ingebritsen, and Jonathon W. Moses (Basingstoke: Macmillan Press, 2000), 5.

[49] Scholte, *Globalization*, 93.

on both policy formation and outcome. Rationalist thinking shapes the interpretation of the changes taking place and defines what makes sense. On a more specific level, neoliberalism as a strain of rationalist thinking has dominated thinking in the present process of globalization. This has a direct impact on the design and adaptation of institutions. Institutions are created to address and solve certain problems, and their design rests on the predominant perception and assumptions of the problem. This leads to the two primary and interrelated global ideational constraints on the state: the neoliberal policy consensus and the lack of analytical equipment and awareness to deal with supraterritorial problems such as global finance. These constraints are interrelated in that the neoliberal policy consensus promotes processes of globalization while simultaneously providing inadequate analytical equipment to deal with the problems generated in the processes of globalization. Subsequently, neoliberal policy consensus and limited global awareness constrained policymakers and increased the impact of globalization.

In finance, ideas and ideology are particularly important. According to McNamara, the reason is "continuing uncertainty over the fundamental workings of the economy, the difficulties of collecting and interpreting signals from macroeconomic data about the effects of policy, and the lack of agreement over what constitutes 'correct' macroeconomic policy."[50] Ideas and interpretation constrain the realm of action. In the present era of globalization, there has been a global transmission of ideas about, for example, inflation that has led to a convergence among states on framing problems and solutions in neoliberal terms.[51] In Europe, McNamara argues, the neo-liberal policy consensus formed out of a perceived failure of Keynesianism, the availability of an alternative monetarist policy paradigm, and the German success with monetarist policies.[52] This policy consensus limited the perceived options and increased the risks of following a different independent path. In so doing, the ideas constrained state policymaking. Kirshner, for example, argues that "ideas, especially when they contribute to normative understandings about 'appropriate' behavior, can create artificial yet powerful constraints on policy."[53]

In the Swedish case, Keynesianism moulded into the so-called Swedish model had provided the paradigm and lens through which policymakers interpreted and framed economic policies in the aftermath of World War II. As Keynesian solutions had failed to revive the Swedish economy in the 1970s and 1980s, the neoliberal discourse gained influence and even the Social Democrats

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[50] Kathleen R. McNamara, "Consensus and Constraint: Ideas and Capital Mobility in European Monetary Integration," *Journal of Common Market Studies* 37, no. 3 (1999): 461.
[51] David M. Andrews and Thomas D. Willett, "Financial Interdependence and the State: International Monetary Relations at Century's End," *International Organization* 51, no. 3 (1997): 491.
[52] McNamara, *The Currency of Ideas*, ch. 6.
[53] Kirshner, "The Inescapable Politics of Money," 15.

shifted towards neoliberal interpretations and policy solutions, especially with regard to inflation.[54] In the early 1990s, there was a firm belief in the neoliberal prescription to solve the problems in the economy among the major parties. As Blyth argues, "the success of business in delegitimating the old ideas of the Swedish model had a marked effect on the policies of both the SAP [i.e. Social Democratic Party] and bourgeois parties."[55] The neoliberal policy prescription entailed a focus on fixed currency and price stability, while full employment became a secondary issue. The determination and consensus of the elites professing this prescription undermined and limited the search for alternative policies. Their belief was influenced by global and European developments, as well as ideological trends in dominant epistemic communities. As Ryner argues:

> There was a vacuum of knowledge among Social Democrats of the workings of finance…. The result was that policy advice was only available from 'academic', non-partisan intellectuals in the universities and the Central Bank. These intellectuals had no organic link with the labour movement. Rather, their links were with fora such as the Bank of International Settlements (BIS), academic networks of economist and business sponsored think-tanks.[56]

However, the neoliberal ideology and agenda that had influenced policy in Europe in the 1980s did not gain a firm foothold in Sweden until the very late 1980s as seen in the relatively late deregulation of capital markets.[57] When the Social Democrats decided to prioritize inflation before employment, the political elite effectively formed a policy consensus around the neoliberal solution of rapidly purging the Swedish economy of inflation.[58] The close to unanimous support of the Swedish political elite in the virtues of neoliberalism obviously constrained their options and search for alternatives.

Globalization also has an influence on the individual level and imposes cognitive constraints on policymakers. At this level, the ideational constraint works through the primacy given to economic and financial reasoning and thinking in public policy. This mindset frames and decides what is regarded as the problem and its proper solution, and who is qualified to make that judgement. Policy alternatives and normative judgements based on other assumptions than those dominant are often dismissed as irrational or unscientific.[59] Steeped in a domestic and state-centric frame of mind and outlook, policymak-

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[54] Ryner, "Neoliberal Globalization,": 65-8.
[55] Blyth, "The Transformation of the Swedish Model,".
[56] Ryner, "Nordic Welfare Capitalism," 43.
[57] Swank, "Social Democratic Welfare States," 99.
[58] Assar Lindbeck, "The Swedish Experiment," *Journal of Economic Literature* 35, no. 3 (1997): 1303. For a structural analysis of the neoliberal turn of SAP, see Ryner, *Capitalist Restructuring*, ch. 7.
[59] Sinclair, "International Capital Mobility," 103.

ers have had difficulties approaching, managing, and adapting to the processes of globalization. The prevalent rationalist knowledge structure, which has been important for the growth of globalization, has not automatically provided the analytical equipment to deal with supraterritorial phenomena. Policies that were suitable in a less global environment have had to be adapted to supraterritoriality. For example, the regulated Swedish financial market prior to deregulation in the 1980s became increasingly outdated as globalization gathered pace. This adaptation takes time, but crisis conditions can work as the catalyst inducing learning and change in policymaking.[60] Policymakers have had to shift their mental constructions of reality and take supraterritorial phenomena into consideration as transworld issues, such as global finance and ecological degradation, have entered and risen on their agendas.[61] Increasing global awareness has facilitated policy adaptation, while lack thereof at least temporarily worsened the externalities of globalization.

The neoliberal policy consensus promoted globalization in a time when the externalities of globalization were both less well understood and disregarded. In this respect, global awareness lagged behind the neoliberal policy consensus. In the Swedish case, deregulation of financial markets took place with scant knowledge or analysis of the impact of such a reform.[62] The obsolete regulation of the financial market mentioned above was framed as a domestic problem that stifled the development of the Swedish economy. The combination of neoliberal policy consensus among the major political parties and the lack of global awareness led them to underestimate the potential consequences of such a reform and constrained their search for alternative policy solutions.

This section has elaborated on the potential global material and ideational constraints that impact on policymakers. The following sections will qualify these constraints in relation to the Swedish financial crisis and the key decision for the policymakers.

6.3. Global constraints in the Swedish financial crisis

The previous section discussed the dynamics and characteristics of global constraints with referrals to the case of the Swedish financial crisis. This section will analyse the global constraints imposed on the Swedish state during the financial crisis with specific attention to the key decisions made during the crisis, i.e. the decision to support of the banks, to defend the krona, and to build a political coalition to increase confidence in the crisis-management effort.

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[60] Stern and Sundelius, “Sweden's Twin Monetary Crises of 1992,”: 34.
[61] Scholte, *Globalization*, 195.
[62] Feldt, *Alla dessa dagar...: I regeringen 1982-1990 [All These Days...: In the Government 1982-1990]*, 260; Jonung, “Den finansiella revolutionen,” 38.

So what were the constraints that globalization imposed on Swedish policymakers in the identified key decisions in the financial crisis? The specific constraints in the Swedish financial crisis were a combination of material and ideational constraints. While the material constraints in the financial crisis limited the actual options for state policy, the ideational constraints limited the perceptions of possible state policy options. Both types of constraints reinforced each other and they are only theoretically separable.

The behaviour of the global financial market

The behaviour of the global financial market came to impose important constraints on all the key decisions made during the Swedish financial crisis. When the Swedish government deregulated the Swedish financial market, it also opened up the Swedish economy to advantages and disadvantages of integration with the global financial market. As the regulations had become increasingly outdated, a massive pent-up demand for credit had developed in the economy and Swedish banks and financial institutions took advantage of the new situation.[63] According to Engwall, the focus of banking institutions shifted from control to marketing and selling.[64] At the same time, the governmental institutions supposed to monitor development in the market were largely unaware and unprepared to counter the rising risk levels from excessive lending.[65] In 1995, the government appointed the Committee on Banking Legislation with the aim to improve the rules for risk management, internal control, and supervision, among other things.[66] The deregulation turned Swedish financial actors into global financial market actors. After the fact, we can see that the banking crisis was a consequence of a mismanaged deregulation, because there were insufficient controls and restraints on the build-up of risk among financial actors.[67] When the threat of a bank collapse materialized the government had to support the banks to keep up the confidence and credibility of the Swedish economy in the global financial market.

The behaviour of the global financial market also came to both influence and constrain the government in the currency crisis in the fall of 1992. When financial deregulation had made it possible for financial actors to exit their

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[63] Beth A. Simmons, "The Internationalization of Capital," in *Continuity and Change in Contemporary Capitalism*, ed. Herbert Kitschelt et al. (Cambridge: Cambridge University Press, 1999), 50-2.
[64] Engwall, "The Swedish Banking Crisis: The Invisible Hand Shaking the Visible Hand," 192.
[65] Gustaf Sjöberg, "Bank- och Finansinspektionens verksamhet 1980-1993 [The Activities of the Bank and Financial Supervisory Authority 1980-1993]," in *Bankkrisen: Rapporter av Håkan Lindgren, Jan Wallander, Gustaf Sjöberg; Bankkriskommitén [The Banking Crisis: Reports from Håkan Lindgren, Jan Wallander, Gustaf Sjöberg; The Banking Crisis Committee]* (Stockholm: Fritzes, 1994).
[66] Englund, "The Swedish Banking Crisis: Roots and Consequences,": 14.
[67] Jonung, "Den finansiella revolutionen," 44.

krona positions, the government had effectively opened the Swedish economy to the constraints and influence of the global financial markets. As the financial crisis deepened and the financial market pressure on the krona increased in the fall of 1992, the government's policy alternatives narrowed to a choice of either intervening to defend the currency peg or to let the currency float. Again, the perception and credibility of the Swedish economy among global financial market actors were crucial to the government's decision to defend the fixed currency and the government mounted a serious effort to augment the external confidence in its economic policy.[68] The Swedish crisis happened in the midst of the EMS/ERM crisis and the volatility and speculative attacks on other European currencies also spilled over to the Swedish economy. Already in the fall of 1991 the Riksbank had had to counter capital outflows with increasing interest rates as a response to the increasing interest rates, primarily in France and Great Britain, and this would continue until the krona began its float on November 19, 1992.[69]

The behaviour of the global financial market also impacted upon and constrained the third key decision, which was to build a broad coalition between the centre-right minority government and the Social Democratic opposition. In order to calm global financial market actors, the minority government needed to strengthen the credibility of its reform policy agenda and display long-term commitment to the fixed currency policy. To accomplish this, the government had little choice but to seek to form a broader political coalition – preferably with the Social Democratic Party, the largest party in opposition. However, according to Bengt Westerberg, the deputy prime minister from 1991 to 1994, the government was not at all confident that the Social Democrats would be interested in providing parliamentary support. Therefore, the government's first meetings with SAP to discuss the potential for cooperation were, from the government's perspective, focused more on determining the Social Democrats' intentions and precluding potential political attacks on a crisis package, than in concrete measures to formalize a coalition.[70] According to Ingvar Carlsson, the leadership of the Social Democrats had started to realize the changing behaviour and impact of global financial markets in the fall of 1990. They understood that international credibility in the financial markets had become more important, and when they presented a proposal aiming to improve the economic situation to the Parliament they also included political initiatives targeting a wider audience than the domestic one.[71]

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[68] Bildt, "Den stapplande vägen till reformer och till Europa," 66.
[69] Dennis, *500%*, 22.
[70] Interview Bengt Westerberg 2004-02-26. See also Bildt, "Den stapplande vägen till reformer och till Europa," 62-3.
[71] Interview Ingvar Carlsson 2004-02-11. See also Carlsson, *Så tänkte jag*, 409.

The behaviour of the global financial market was the context and rationale for the key decisions in the financial crisis. It came to constrain and structure the decisions of policymakers.

Widening resource gap

A consequence of global financial market behaviour is the resource gap that has opened up between the resources available to governments and those aggregated in the global financial market. This discrepancy has increased the constraints on and vulnerability of the state to the volatility of the financial market. When financial market actors instantly can exit one market for better opportunities in another, their veto power on governmental policies has increased.[72] The rapid development and growth of the financial market since the early 1990s have further widened the resource gap,[73] but it was wide enough in the early 1990s to constrain the options available to the Swedish government. The vast gap between domestic and external resources imposes one of the more obvious constraints on any state trying to defy the direction and expectations of the financial market. As Germain points out, "by virtue of the dramatic increase in the amount of international credit provided by private monetary authorities, the direction of international credit flows has become largely determined by these private authorities."[74]

As discussed in chapter four, increasing budget deficits, mounting national debt, growing unemployment, high real interest rates, and a recession had created fundamental imbalances in the Swedish economy.[75] The dismal and deteriorating condition of the Swedish economy at the time of the financial crisis meant that the government already had inadequate resources at its disposal to pursue independent strategies. The IMF delegation that visited Sweden in May 1992 was concerned about further deteriorating public finances and warned of "probable additional pressures on the budget that might arise from needing to support the domestic financial sector."[76] Long-term economic stagnation and insufficient structural economic reform had put the Swedish state in a situation where its available resources put limitations on available alternatives to pursue. When the Swedish economy suddenly entered the bust phase of the financial crisis, the resource constraints increased rapidly. As Pierson points out, it did not take more than four years for the Swedish economy to go from turning out the largest budget surplus in the OECD to having the largest deficit

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[72] Cohen, *The Geography of Money*, 132-3.
[73] Wästberg, *Det tomma rummet: Om politikens vanmakt [The Empty Room: On the Powerlessness of Politics]*, 82., see also section 3 in chapter 2.
[74] Randall D. Germain, *The International Organization of Credit: States and Global Finance in the World Economy* (Cambridge: Cambridge University Press, 1997), 163.
[75] Dennis, *500%*, 343.
[76] IMF, *Sweden: Staff Report for the 1992 Interim Article IV Consultation* (Washington, DC, 1992), 14, SM/92/124.

and government expenditures reaching the extraordinary level of 73 percent of GDP in 1993. [77] Thus, limited resources in comparison with the vast resources available in the global financial markets came to constrain Swedish policymakers in their decisions.

The constraint imposed by a widening resource gap is probably the most obvious in the currency crisis. There was a significant discrepancy between the financial resources at the disposal of the government in comparison with the vast sums moved by currency traders. The Riksbank repeatedly intervened in the market to prop up the currency and for a long time it seemed that the foreign exchange reserves were sufficient to uphold the currency peg. The Riksbank together with the Swedish National Debt Office (Riksgäldskontoret) began replenishing the reserves during the fall of 1992 to the extent that Sweden turned into the largest borrower among state and suprastate borrowers in the international capital market, accounting for 20 percent of their total loans in the period September 1992-June 1993. This was twice as much as the second largest borrower, the World Bank.[78] Still, this would not be enough to close the resource gap and pursue the preferred policy of a fixed currency. In the end the high interest rates and multiple interventions that almost depleted the reserves were insufficient to artificially balance demand and supply of krona in the market. When too many financial actors simultaneously wanted to exit their Swedish currency positions, the resources available to currency traders outstripped the resources available to the government.

The broad political coalition is only indirectly related to the material constraint imposed by the widening resource gap. Both the government and the Social Democratic opposition saw the coalition as necessary to give the crisis packages credibility and start the reforms of the Swedish economy that in the future would improve the resourcefulness of the Swedish economy.[79] The coalition helped display the firmness of this commitment, which reinsured the global financial market and thereby slowed the excess supply of krona in the foreign exchange market.[80] This facilitated the defence of the currency peg in the fall of 1992. In this respect, the broad political coalition was a necessary response to the widening resource gap and helped extend limited Swedish resources.

The resource constraints during the currency crisis part of the Swedish financial crisis were compounded by the simultaneous banking crisis. The banking crisis emanated out of the financial deregulation, imprudent lending from financial institutions, and lack of governmental supervision in the transformed environment. In the decision to support the banks, the government had to as-

[77] Pierson, "The New Politics of the Welfare State,": 171.
[78] Dennis, *500%*, 45.
[79] Ibid., 57.
[80] Wibble, *Två cigg och en kopp kaffe*, 30-34.

sess the risks of a run on the banks. Such a run could have forced the government to re-regulate the financial market, brought economic activity to a standstill, and destabilized the whole society.[81] As seen in Argentina's financial crisis recently, the effects of a bank run and ensuing systemic collapse can rapidly reach a magnitude that causes social unrest and instability.[82] It was necessary for the government to dismantle the threat of a systemic crisis and provide the resources to stabilize the banking system. Nevertheless, the governmental support of the banks ended up costing the public 74 billion krona or 5 percent of GDP in 1991 and 1992,[83] which of course worsened the growing budget deficit and tied resources that could have been useful elsewhere. However, without this successful effort to stabilize the banking system, the effort to defend the krona in the fall of 1992 would have had even smaller chances of success.

The government's decision to support the banks, although tentative, was sufficient to alleviate some of the immediate pressure on the banks and thereby countered the prospects of a run on the banks. Bo Lundgren, minister of taxation and banking during the financial crisis, argues that the support of the banks was necessary, because of the substantial foreign loans to the Swedish banking system of approximately 300 billion krona. Unless the credibility of the Swedish banking system had been restored, many foreign banks could have withdrawn this credit with consequences as devastating as those experienced during the Asian financial crisis a few years later. In Lundgren's view, there was no alternative to supporting the banks, but the government did have a few options in managing the support of the banks.[84]

By supporting the banks, the government was able to pursue the defence of the fixed currency. However, the prolonged defence simultaneously worsened the banking crisis in that the persistently high interest rates forced companies into bankruptcy and turned their loans into non-performing credit for the banks. It went so far that the defence of the krona almost forced the large commercial banks S-E Banken and Handelsbanken into bankruptcy and state management.[85] The high real interest rates and credit losses stretched their limited resources to the extreme. Lars Heikensten, chief economist at Handelsbanken during the crisis, points out that had the krona not fallen when it did, it would probably have been only a matter of weeks before S-E Banken and Handelsbanken would have had to join the other banks at the Bank Support Authority.[86]

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[81] Bo Lundgren, *När bubblan brast: Om den svåraste finanskrisen i Sveriges historia [When the Bubble Burst: On the Most Difficult Financial Crisis in Sweden's History]* (Stockholm: Bokförlaget DN, 1998), 30-2.

[82] "Argentina's Collapse: A Decline without Parallel," *The Economist*, March 2nd-8th 2002.

[83] OECD, *OECD Economic Surveys 1993-1994: Sweden* (Paris: Organisation for Economic Co-operation and Development, 1994), 129.

[84] Lundgren, *När bubblan brast*, 326-7.

[85] See, for example, Ibid., 235, 240-1.

[86] Interview with Lars Heikensten, 2004-03-02. In the end, neither S-E Banken nor Handelsbanken received any support from the Bank Support Authority. Ibid., 329.

That would have constituted a decisively bigger commitment for the state and could have spelled the failure of the bank support effort. A consequence of the globalizing economy is the widening of the resource gap between state actors and the financial market. The finite resources of the Swedish state paired with the incredible resourcefulness of the global financial market certainly limited the options available for state policies during the financial crisis.

Global institutions

In the 1980s and early 1990s, international institutions promoted further liberalization of financial markets, while underestimating and largely disregarding the risks of global finance. Prominent international organizations dealing with global finance, such as the OECD, the IMF, and the BIS, still had a macroeconomic and/or very technical central banking focus in developed countries. Problems relating to financial stability were not an issue and perceived to be beyond their mandates.[87]

It was only after the Mexican Peso crisis in 1994 that the idea of reforming the international financial architecture gained a foothold and the multiple financial crises of the 1990s pushed international institutions to addressing the issue. [88] Some even argue that it was only after the Federal Reserve Bank of New York bailed out the collapsed Long-Term Capital Management in order to prevent the systemic collapse of Wall Street that the case for reform was made.[89]

The recurrent financial crises led to the realization that the problems at hand had to be dealt with collectively at the global level. There are now a number of intergovernmental institutions dealing with financial stability. For example, the Financial Sector Assessment Program (FSAP) is a joint IMF/World Bank effort to promote financial soundness in members' financial systems. The FSAP was established first in 1999.[90] In the same year, the G-7 launched the Financial Stability Forum and the G-20 to address these issues. These institutions bring together different constellations of representatives from G-7 countries, emerging markets and existing international institutions concerned with international financial regulation, such as the OECD, IMF, BIS, the Basle Committee on Banking Supervision and the International Organisation of Securities Com-

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[87] Phone interviews with Stefan Ingves, 2004-02-26, and Pierre Vinde, 2004-03-24. See also Nils Lundgren, "Per aspera ad astra - Sveriges väg till samhällsekonomisk balans [Per Aspera Ad Astra: Sweden's Road to Socio-Economic Equilibrium]," in *På jakt efter ett nytt ankare: Från fast kronkurs till inflationsmål [In Pursuit of a New Anchor: From a Fixed Krona to an Inflation Target]*, ed. Lars Jonung (Stockholm: SNS Förlag, 2003), 398.

[88] Jacqueline Best, "From the Top-Down: The New Financial Architecture and the Re-embedding of Global Finance," *New Political Economy* 8, no. 3 (2003): 373.

[89] Valpy FitzGerald, "The Security of International Finance," in *Globalization and Insecurity: Political, Economic and Physical Challenges*, ed. Barbara Harriss-White (Basingstoke: Palgrave, 2002), 156.

[90] IMF, "Transcript of an Economic Forum - Ensuring Financial Stability: The IMF's Role," (Washington, DC: International Monetary Fund, 2003).

missions (IOSCO). This was accompanied by much discussion and further changes in existing institutions as part of the focus on reform of the international financial architecture.[91]

For most states, adhering to international institutions dealing with financial stability has been one measure to minimize the negative effects of volatile global financial markets. The state faces a trade-off between different types of global constraints. The trade-off is between constraints imposed by unfettered global financial markets or the constraints imposed by the norms, codes of conduct, best practices etc. that are formalized in international institutions. Usually, following the codes and treaties of international institutions has been deemed preferable to the discretionary constraints levied by the global financial market.[92]

At the time of the Swedish financial crisis, however, there was no such trade-off, because the crisis happened 'pre-re-regulation'. International institutions still focused on promoting financial liberalization rather than financial stability. The promotion of capital account liberalization was often indirect and worked through peer pressure. For example, in promoting financial deregulation, the OECD listed regulations on capital movements in member countries and Sweden, having the longest list of regulations, used to get a round of applause from the participants whenever a regulation disappeared.[93]

In retrospect, Sweden would probably have been better off with tighter global constraints levied by international institutions. External pressure could, for example, have triggered earlier political action to manage the developing crisis and that could have improved the options available to the policymakers in the crisis management effort. Instead, Swedish economic policy and strategy won the approval of delegations from the IMF, the OECD, and the EC., according to Minister of Finance Anne Wibble[94]

Another example of the public approval expressed by international institutions is the concluding remarks from IMF's Article IV consultation in May 1992. More than a decade later, Carl Bildt still uses these remarks to justify the actions of the government. The IMF concluded:

> To sum up, we fully support the present macroeconomic strategy, which we believe offers Sweden the best prospect for breaking with

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[91] See, for example, Eichengreen, *Toward a New International Financial Architecture*.

[92] For example, as a member of the IMF, Sweden has formally agreed not to implement exchange rate adjustments unless there are fundamental imbalances in the economy. See Lars Wohlin, "Svensk valutapolitik - tillbakablick och framtid i ett integrerat Europa [Swedish Currency Policy: A Look Backwards and Forward in an Integrated Europe]," in *Devalveringen 1982 - rivstart eller snedtändning? Perspektiv på svensk devalveringspolitik [The 1982 Devaluation: Flying Start or Misfiring? Perspectives on Swedish Devaluation Policy]*, ed. Lars Jonung (Stockholm: SNS Förlag, 1991), 385.

[93] Phone interview with Stefan Ingves, 2004-02-26.

[94] Hamilton and Stuart, "I stormens öga," 115.

> the relative slowdown in productivity growth during the past decade. However, the successful implementation of this strategy will require both firm resolve in the pursuit of restrictive policies over time and early action to place the budget deficit on a clearly declining path. We have every confidence that such a course would substantially enhance the credibility in the overall policy strategy thereby allowing the fruits of that strategy to be realized.[95]

These remarks are significant in their focus on the macroeconomic situation rather than financial stability. Furthermore, the remarks show neither alarm nor pressure on the Swedish government to pre-emptively deal with what would become the country's worst financial crisis since the 1930s. The general public was left with the impression that the IMF gave the government its blessing.

Prior to the mid-1990s, the IMF's general policy was to not make its views on national economies available to the general public. Furthermore, whenever there were risks for severe market reactions, the IMF was extremely cautious in its public relations with governments as well as in written IMF staff reports. Simply raising the subject of potential financial crisis was deemed to be potentially destabilizing. Therefore, both the government and the IMF kept the visits and the advice of the IMF delegations as confidential as possible in order to avoid leaks.[96]

Although the public impression is that the IMF supported the policies of the government, in fact the visiting IMF delegation warned the government that the IMF's early-warning indicators were signalling that the Swedish economy was approaching a financial crisis situation and that immediate measures were needed to improve the situation.[97] According to both Desmond Lachman, the head of IMF's Article IV delegations to Sweden in 1992 and 1993, and Åke Lönnberg, the IMF's point of contact at the Riksbank, the IMF delegation was explicit in voicing its concerns to officials at the Riksbank and at the Ministry of Finance, as well as to the government. However, for fear of unsettling the markets, they never made their warnings public.[98] According to Lachman, the Riksbank was prepared to raise short-term interest rates to unsustainably high levels and to deplete its international reserves to defend the currency. However, Lachman's diagnosis suggested that the currency was seriously overvalued and that the public finances were in need of serious correction. On that basis, he be-

[95] Quote from Bildt, "Den stapplande vägen till reformer och till Europa," 60.
[96] Phone interview with Åke Lönnberg, 2004-06-09.
[97] Phone interview with Desmond Lachman, 2004-06-08.
[98] Phone interviews with Desmond Lachman, 2004-06-08, and Åke Lönnberg, 2004-06-09. Lönnberg stresses that he never participated in meetings the IMF delegations had with the Ministry of Finance or the government and can thus not confirm what was said on those occasions. However, the point was made at meetings with the Riksbank at which he was present. See also Dennis, *500%*, 64-5.

lieved that the floating of the currency was the right thing to do and that serious fiscal consolidation was needed to support the currency.[99]

Hamilton and Stuart corroborate Lachman's and Lönnberg's accounts of the IMF voicing its scepticism of the currency defence directly to the government just before the currency began its float. Their research reveals that in confidential memoranda from the IMF to Minister of Finance Anne Wibble, the IMF deemed the success of the currency defence very unlikely just days before it actually fell.[100]

Since Sweden did not envisage drawing its IMF quota, the IMF did not have sufficient leverage to convince the Swedish government of either the seriousness of the situation or the proper policies to pursue, especially with regard to the defence of the currency. For example, Lachman expresses astonishment that the Riksbank was prepared to raise the short-term interest rate to 500 percent and to draw down its international reserves by US$25 billion in four days in defence of the krona long after some major European currencies had been forced to realign during the ERM crisis in the early fall of 1992.[101]

Despite its lack of leverage, the IMF still played an important role in that it provided an outside perspective and assessment of the situation that was valuable for the government.[102] As the IMF's representative, Lachman was invited to Sweden a number of times prior to the fall of the krona, primarily by Bengt Dennis, the governor of the Riksbank. Lachman played the important role of the outside broker, advising and pushing the different parties in the minority government and the Social Democratic opposition to find common ground and pull in the same direction with regard to correcting Sweden's severe fiscal imbalance.[103] In this respect, the IMF came to facilitate the policies and crisis management effort of the government.

The banking crisis is also an example where the lack of global institutions came to constrain the options of the government. The deregulation of the financial market had been promoted by international institutions such as the OECD, IMF, and BIS, but there was only scant advice on the downside and risks involved in deregulation. BIS, for example, admitted that the rapid credit growth sometimes had been "discounted as an innocuous by-product of deregulation" and that "the rapidly changing contours of the financial system complicated the authorities' task."[104] Many governments deregulated their financial markets in the 1980s without taking sufficient measures to accommodate the policy change and suffered financial crises as a consequence. Although the Basle Accord of

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[99] Phone interview with Desmond Lachman, 2004-06-08.
[100] Hamilton and Stuart, "I stormens öga," 155-6.
[101] Phone interview with Desmond Lachman, 2004-06-08.
[102] Bildt, "Den stapplande vägen till reformer och till Europa," 60.
[103] Phone interview with Desmond Lachman, 2004-06-08. See also Carlsson, *Så tänkte jag*, 488.
[104] Bank for International Settlements, *63d Annual Report*, 167.

1988 laid out rules and regulations such as capital adequacy ratios for banks in an attempt to monitor and diminish the risks in the banking system, it was not sufficient to prevent the severe Swedish banking crisis.[105] Global rules, pressures, and advice were too poor or misguided to facilitate deregulation of financial markets without triggering financial crises.

In all, there was a lack of global institutional constraints: without the support, external pressure, or intervention of international institutions, the Swedish financial crisis deepened and the unfettered global financial market came to impose the global constraint instead. By contrast, it seems unlikely that the present make-up of international institutions of today would have allowed the Swedish situation deteriorate to such an extent before advising, alerting, intervening, aiding, and/or disciplining the Swedish government. The global financial architecture is still underdeveloped, but it has changed since the early 1990s. What critics of neoliberalism have called "new constitutionalism" or "disciplinary neo-liberalism"[106] was not strong enough to help the Swedish state save itself from the financial crisis and the impact of global finance. Instead, it went so far that the financial market had to administer the discipline and forcibly induce the necessary reforms. With insufficient support and leverage from the global institutional framework, the Swedish government had to face the global financial market on its own.

Regional institutions - ERM crisis and EC membership

As argued in the previous section, approaching the EC could be seen as an intermediate strategy to improve the capacity to deal with the effects of globalization. In that respect, the qualification for membership and events within the EC came to influence and constrain policymakers during the Swedish financial crisis. In all the key decisions, the EC played at least an indirect role. Neither devaluation, a bank run, nor the political elite being incapable of managing the crisis would have improved the attractiveness of Sweden as a member in the EC.

The backdrop to the Swedish financial crisis was the ongoing European currency turbulence. The German reunification had led to higher interest rates and the strong economic position of Germany made the interest rate hikes spill over into European as well as Swedish financial markets. This worsened the real-interest rate shock already experienced in Sweden and further deepened the recession.

The Swedish krona suffered from a lack of firm association with another currency or currency basket. The unilateral peg to the rather unstable ECU was

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[105] For a positive view of the Basle Accord, see Ethan B. Kapstein, *Governing the Global Economy: International Finance and the State* (Cambridge, MA: Harvard University Press, 1994), ch. 5.

[106] Gill, "The Global Panopticon?,".

insufficient to bolster the credibility of the Swedish defence of the krona and the government searched for a more credible association of the krona. There were suggestions of pegging the krona to the D-mark and a closer association to the ERM and EMS.[107] During the fall of 1992, the Swedish government approached the EC's monetary committee for support several times, but they were continuously rebuffed. Although Jean Claude Trichet, the French chairman of the committee, was positive to Sweden's propositions, the other countries would not come to a decision on the issue before the Riksbank finally had to let the krona float.[108]

It was obviously hard to negotiate out of a position of weakness and even more so when the ERM countries struggled with their own turbulent currency situation. The continuous interventions of the Riksbank in order to hold the fixed currency also worsened the situation in the ERM countries and they expressed criticism of the interventions.[109] At the same time, the Swedish government wanted the backing of the EC countries to draw on the pool of resources and credibility available there and take an important step on the way to full exchange rate cooperation within a membership in the EC.[110] For the members of the European Community, it turned out to be too far-reaching a proposition to help an applicant in trouble. European solidarity did not stretch that far.[111]

Sweden was also constrained in dealing with the financial crisis by the pending formalization of its relationship with the EC. In adapting to the globalizing economy, joining the EC was an important step. When the Riksbank fixed the krona to the ECU in May 1991, it was perceived as an expression of Sweden's ambition to join the EC. It cemented the connection between the fixed currency and the new policy toward Europe. The importance of Europe for the government's decisions is also emphasised by Carl Bildt, the prime minister during the crisis, who regards the currency defence as an episode in the greater story of Sweden overcoming its isolation in Europe.[112]

It was a Social Democratic government that had launched the initiative to join the EC in 1990, but the incoming bourgeois coalition saw it as its mission to

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107 Dennis, *500%*, 237.

108 Bildt, "Den stapplande vägen till reformer och till Europa," 76, 84; Hamilton and Stuart, "I stormens öga," 124, 159-60.

109 Dennis, *500%*, 270.

110 Ibid., 286.

111 On a side, the vain search for EC support of the krona, while neither being a member, mutual contributor, or participant in the organization, shows striking similarities with the fortunately never tested military plans in Sweden. During the Cold War, non-aligned Sweden set its hopes and structured its forces on the assumption that they would hold out from an attacking Soviet Union until outside intervention (i.e. NATO) came to the rescue. Sweden pursued a dangerous strategy of banking on the goodwill and interests of other governments, while dismissing the mutual obligations of an alliance. Whether the issue is military or economic security, applying for shelter and support is more effective from a position of strength and without the direct need of help.

112 Bildt, "Den stapplande vägen till reformer och till Europa," 54.

follow through on membership. Upon forming a government in the fall of 1991, the centre-right minority government set the ambitious target of joining the EC by 1995.[113] That meant negotiating the terms of membership while simultaneously dealing with the structural problems in the Swedish economy to clear the way for membership. Shortly thereafter, the Maastricht Treaty outlined the roadmap from the single market to economic and monetary union. The treaty increased the pressure for reforms further, but the government confirmed its determination to become a member also on these terms.[114] Considering that Sweden, together with Greece, had the furthest to go among the prospective EMU countries when it came to reducing the budget deficit to the EMU standards outlined in the Maastricht treaty,[115] that government had a formidable agenda.

The government had a strong urge to make a good impression on the countries in the EC. A devaluation of the currency would, just as in the 'super-devaluation' of 1982, export Swedish problems abroad and primarily onto important trading partners which were already EC members. Rather than making Sweden worthy and attractive as a member of the EC, the government feared that devaluation would not only postpone the solution to the structural problems in the Swedish economy, but also force EC members to pay for the delay. The government's intention to join the EC coincided with the EC consolidating its position as a global actor through the closer cooperation outlined in the Maastricht treaty.[116]

It is debatable whether regionalization as a state strategy to manage and reduce the constraints of globalization is a success. Hay, for example, points out the irony of attempting to ensure the European social model through regional economic integration, while the process of integration has served the institutionalization of neoliberalism.[117] However, Swedish policymaking during the financial crisis cannot be seen separate from the development in Europe and the government intention to join the EC as soon as possible. The process of regionalization both influenced and constrained Swedish policymaking.

Ideational constraints - Neoliberal ideas

The Swedish financial crisis happened when the neoliberal policy consensus and the so-called 'Washington consensus' was still at its prime. After the suc-

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[113] Ibid., 56.

[114] Ibid., 56-7.

[115] Kathleen R. McNamara, "Globalization, Institutions, and Convergence: Fiscal Adjustment in Europe," in *Governance in a Global Economy: Political Authority in Transition*, ed. Miles Kahler and David A. Lake (Princeton, NJ: Princeton University Press, 2003), 343.

[116] Interview with Carl B. Hamilton, 2004-03-10. For a critical view of fixing the krona to the ECU, see Wohlin, "Svensk valutapolitik," 385-7.

[117] Hay, "Contemporary Capitalism, Globalization, Regionalization and the Persistence of National Variation,": 521.

cessful resolution of the Latin American debt problems in the late 1980s, the US treasury, the IMF, and many representatives of advanced economies had come to the conclusion that the path to prosperity for the developed and emerging markets alike rested on a greater reliance on market forces and that meant further liberalization and privatization of their economies. The key element of the Washington consensus was that free trade complemented with the deregulation of domestic financial markets would unleash the full potential of participation in the integrated global economy.[118] The result would be further prosperity and continued growth and development for these economies.

This recommendation was of course rather crude, but it was a ubiquitous neoliberal remedy that already had been applied in many advanced economies in the 1980s. However, the mixed results of financial deregulation, and the threat and potential cost of banking and currency problems in the aftermath of financial market deregulation had neither been factored in nor recognized yet. The Washington consensus did not break down until the end of the 1990s, when Mexico, many East Asian countries, Russia and Brazil among others had suffered severe financial crises and the realization spread that financial deregulation had to be carefully managed in order to succeed.

In this context of rapid economic globalization and with poorly performing domestic economies, it is not surprising that advanced industrialized countries, such as Sweden, Norway, and Finland, took the cue and inspiration from neoliberal ideas.[119] As McNamara points out, "the inability of the Left to come up with effective alternatives to monetary rigour meant orthodox views of the primacy of price stability took hold more easily."[120] The rise of neoliberal orthodoxy in Sweden can be traced to the economic policies of the Social Democratic government in the mid-1980s.[121] The priorities of the government shifted towards price stability, external balance, and economic growth. They also denounced the option of devaluation after the so-called 'super-devaluation' in 1982, deregulated financial markets, and increased the autonomy of the Riksbank.[122] According to Ryner, "rather than attempting to minimize the exposure of the Swedish economy to global financial markets, this exposure was maximized."[123] This market orientation was in accordance with the aims of Kjell-Olof Feldt, the Social Democratic Finance Minister. However, he regrets the lack of

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[118] Michael Mastanduno, "Models, Markets, and Power: Political Economy in the Asia-Pacific, 1989-99," *Review of International Studies* 26, no. 4 (2000): 500.
[119] See, for example, Evelyne Huber and John D. Stephens, "Internationalization and the Social Democratic Model: Crisis and Future Prospects," *Comparative Political Studies* 31, no. 3 (1998).
[120] McNamara, "Consensus and Constraint,": 466.
[121] Ryner, "Nordic Welfare Capitalism," 37.
[122] Swank, *Global Capital, Political Institutions, and Policy Change*, 135. See also Evelyne Huber and John D. Stephens, *Development and Crisis of the Welfare State: Parties and Policies in Global Markets* (Chicago, IL: 2001), 241-3.
[123] Ryner, "Nordic Welfare Capitalism," 37.

discussion regarding the consequences of increasing internationalization on Swedish economy and society.[124]

In 1991, the centre-right minority government took over from the Social Democrats on a platform called "New start for Sweden", where they distanced themselves from the Swedish model and the perceived policy mistakes therein, and laid out their plans to move the economy further in the neoliberal direction.[125] In the key decisions of the financial crisis, the neoliberal policy constraint is most obvious in the decision to defend the currency. The government regarded Keynesian stabilization policy as the actual cause of economic instability.[126] Instead, they asserted the neoliberal solution of battling inflation and holding the fixed currency without regard to the economic circumstances.[127] This came to prolong the defence of the currency for months after major European currencies had been forced to devalue.

In the decision to build a broad political coalition to defend the currency and support the banks, the neoliberal policy consensus facilitated an agreement, but also constrained the search for policy alternatives. Internationally, there was a quick integration of the neoliberal perspective into the mainstream of economic thought in the 1980s.[128] In Sweden, on the other hand, it took longer time but the political and economic elites converted from a Keynesian accommodation policy to a monetarist non-accommodation policy.[129] In the fall of 1992, the minority government had a credibility problem and needed a parliamentary majority to increase the chances of convincing the global financial markets of its intentions to reform the economy.[130] As argued above, both the government and opposition were convinced of the virtues of a fixed currency, price stability and the detrimental effects of devaluation and this made it easier to agree on crisis packages. The political consensus on framing the problem and its solution in neoliberal terms made contingency plans unnecessary. As Stern and Sundelius argue, "the elite participants were locked into a cognitive frame, within which

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[124] Feldt, *Alla dessa dagar...: I regeringen 1982-1990 [All These Days...: In the Government 1982-1990]*, 409. Interview with Kjell-Olof Feldt, 2004-02-10.

[125] Bildt, "Den stapplande vägen till reformer och till Europa," 56.

[126] Hamilton and Rolander, *Att leda Sverige in i krisen*, 33.

[127] Blyth, "The Transformation of the Swedish Model,": 22.

[128] Jonathan Kirshner, "The Political Economy of Low Inflation," *Journal of Economic Surveys* 15, no. 1 (2001): 43.

[129] On the paradigm shift in Swedish economic policy, see Lars Calmfors, "Nationalekonomernas roll under det senaste decenniet: Vilka är lärdomarna? [The Role of the Economists during the Last Decade: What Are the Lessons?]," in *Ekonomerna i debatten: Gör de någon nytta? [The Economists in the Debate: Are They Useful?]*, ed. Lars Jonung (Stockholm: Ekerlids Förlag, 1996), 226-30. On the conformism in the Swedish economic debate, see Björn Elmbrant, *Så föll den svenska modellen [Thus Collapsed the Swedish Model]* (Stockholm: Fischer & Co, 1993), 310-1.

[130] Bildt, "Den stapplande vägen till reformer och till Europa," 66.

the value to the nation of the fixed-exchange rate policy was taken as axiomatic."[131]

In the decision to support the banks, however, the neoliberal solution is somewhat surprisingly disregarded. From a neoliberal perspective, state intervention should be minimized. In the crisis, the Swedish government had to increase its involvement and ownership in the banking sector, when it would have preferred to diminish it.[132] In the circumstances, the government decided to shoulder the role as lender of last resort and to protect the financial system. However, the bank support has been questioned for being too generous, since it not only ensured the stability of the financial system, but also protected the actual banks, which thwarted competition in the Swedish banking sector.[133]

In sum, the neoliberal policy consensus spilled over into Sweden and came to constrain the government's search and implementation of policy alternatives during the crisis.

Global awareness

The growth of supraterritorial relations among people has led to increasing global awareness. In the financial realm, the many financial crises of the 1990s have forced global consciousness upon policymakers. For example, as Leblang points out, "the spectre of future attacks has forced state leaders to reconsider the limits of national sovereignty and the appropriate organization of nation-states."[134] There are of course both structural and agency dimensions to global awareness. This section focuses on the structural dimension whereas the next chapter will analyse the agency dimension.

Global awareness both constrains and enables policymakers. On the one hand, global consciousness is a prerequisite for policy adaptation to the structural impact of global phenomena. Limited global awareness precludes proactive and preventive measures to avoid a financial crisis. From this perspective, awareness enables policymakers whereas limited awareness constrains them. On the other hand, global consciousness can divert attention from domestic issues of more importance or even cause unwanted effects. As Sinclair points out, the most important aspect of capital mobility is not the actual flows but "the impact the *potential* for capital mobility…has on social practices."[135] The intersubjective nature of global finance impacts on the behaviour of policymakers. From this perspective global consciousness constrains rather than enables the

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131 Stern and Sundelius, "Sweden's Twin Monetary Crises of 1992,": 40.
132 Larsson, *Staten och kapitalet*, 32.
133 Larsson and Sjögren, *Vägen till och från bankkrisen*, 164.
134 Leblang and Bernhard, "The Politics of Speculative Attack in Industrial Democracies,": 291.
135 Sinclair, "International Capital Mobility," 95.

policymaker and promotes the status quo rather than proactive measures to manage financial crisis.

Here the argument is made that the Swedish financial crisis happened before the formation of global consciousness among the political and economic elites. This constrained their ability to manage the crisis effectively. Instead, the lack of global awareness facilitated and increased the impact of the other global constraints. For example, as Ryner argues, by deregulating financial markets, "the Ministry of Finance and the Central Bank deliberately sought to amplify the territorial non-correspondence between global financial markets and collective and state bargaining, for disciplinary purposes."[136] However, although this policy shift was meant to exert market discipline on collective actors, it also produced much wider and unpredictable consequences in exposing the Swedish economy to the pressures of global finance.[137] It seems reasonable that globally conscious and cautious policymakers introducing a major policy change would have taken measures to limit and prevent unintended consequences, such as financial crisis.[138] Instead, the structural impact of global finance was not restrained by policy measures. As the crisis developed, however, policymakers became globally aware and managed to adapt some of their policies toward a global audience. In other words, they started to take the intersubjective nature of global finance into account when making policies. This enabled them in some respects and constrained them in others. It enabled policymakers in that they successfully managed the banking crisis and extended the defence of the currency, while it constrained policymakers in that they had to take the global financial markets into account when making policy.

Although the neoliberal policy consensus promoted and facilitated the integration of the Swedish economy in the global economy, it did not recognize or simultaneously provide measures to deal with the externalities of globalization. Policymakers sometimes use globalization as a self-serving tool to justify or legitimize reforms or deflect accountability of failures. Hay and Rosamond, for example, make the argument that "globalization has become a key referent of contemporary political discourse and, increasingly, a lens through which policy-makers view the context in which they find themselves."[139] However, in the Swedish financial crisis, there was very limited global awareness among the policymakers and they did not use the externalities of globalization to justify preventive measures prior to the financial crisis. According to Pierre, leading

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[136] Ryner, "Neoliberal Globalization,": 62.
[137] For example, Jervis points out that "interconnections and interactions create sufficient complexity so that it would be surprising if the results conformed to the statesman's anticipation." Jervis, *System Effects*, 65.
[138] This study has found no signs of contingency planning in the literature or interviews regarding the Swedish financial market deregulation.
[139] Hay and Rosamond, "Globalization, European Integration and the Discursive Construction of Economic Imperatives,": 148.

politicians had limited understanding of the Swedish economy being scrutinized in the global financial markets, and neither did they realize the strength of the attack on the currency nor what measures would be necessary to end the speculation.[140] The crisis happened before global finance had entered political discourse. Lacking global awareness, policymakers still thought primarily in terms of interstate relations and separated domestic and foreign affairs.

Consequently, policymakers focused their attention in the wrong direction. In trying to solve a domestic problem with inflation and dysfunctional financial markets through deregulation, policymakers simultaneously opened the Swedish economy to externalities of the global financial market. The notion of space was still territorial and financial threats and vulnerabilities were still perceived in territorial, rather than in supraterritorial terms. Policymakers had not yet realized the consequences of globalizing financial markets and therefore the global financial constraints caught them by surprise, and they were unprepared to deal with the consequences.

Awareness is of course one of the first hurdles to pass in order to adapt and survive in a changing environment. The ancient Chinese military strategist, Sun-Tzu made this realization and advised his generals:

> Know you enemy and know yourself; in a hundred battles, you will never be defeated. When you are ignorant about the enemy, but know yourself, your chances of winning and losing are equal. If ignorant both of your enemy and of yourself, you are sure to be defeated in every battle.[141]

Applying this dictum to the Swedish financial crisis, the argument can be made that Swedish policymakers were ignorant both of themselves and of the "enemy", i.e. the global financial market, after deregulating the Swedish financial market. According to Nils Lundgren, chief economist at Nordbanken during the crisis, most economists, politicians and technocrats were "out of step with the historical development."[142]

Without understanding the new financial environment after deregulation, consecutive Swedish governments failed to take the proper measures to diminish the economic exposure to financial instability and possibly avert the financial crisis at an earlier stage. Neither Swedish political or economic elites provided what Albert Hirschman calls an "action-arousing gloomy vision"[143] in time to avoid the financial crisis. Such a vision could have been effective in making policymakers and the general population believe that the danger could

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[140] Pierre, *Marknaden som politisk aktör*, 49.
[141] Sun Tzu, *The Art of War* (Ware: Wordsworth Reference, 1993), 106.
[142] Lundgren, "Per aspera ad astra - Sveriges väg till samhällsekonomisk balans [Per Aspera Ad Astra: Sweden's Road to Socio-Economic Equilibrium]," 397. My translation.
[143] Quote from Jervis, *System Effects*, 264.

be coped with by strenuous effort. The anticipation of the danger could have led them to struggle to overcome it. In the Nordic countries, Denmark was the only country that came out of its deregulation process without a serious financial crisis. With the right measures, Danish policymakers managed to adapt the Danish economy to the new environment without incurring the costs of a serious financial crisis.[144]

Global awareness forced itself into the consciousness of policymakers and the general population during the financial crisis. Rather than being globally aware and implementing the necessary measures that could have pre-empted the consequences of deregulation and economic integration, the financial crisis caught both policymakers and the public by surprise and forced them to become globally aware. During the financial crisis, however, it became very clear to policymakers that globalization matters and they went through a fast learning process. For example, Olle Wästberg, state secretary in the Ministry of Finance during the crisis, has remarked that during the financial crisis he made the experiment of clocking the time for the words of Anne Wibble, the finance minister, to hit the Reuter screens and found the answer to be 60 seconds.[145] Once global awareness had settled in, however, it triggered a far-reaching reevaluation of policies and legislation. According to Jonung, no other Swedish economic crisis during the 20th century has generated such substantial changes in the legislative framework surrounding fiscal and monetary policy.[146]

The limited global awareness came to exacerbate the global constraints imposed on policymakers during the crisis. The lack of global awareness is most obvious in the decision to defend the currency. The government followed its policy regardless of what happened in its environment, including the decision by some of its major European trading partners to realign their currencies.[147] In the midst of the ERM crisis, a better understanding of the global financial market could have led the government to pursue a different policy. Instead, one of the most market-oriented Swedish governments ever held on to its fixed currency policy at a time when it already faced severe structural economic imbalances, an overvalued currency and a recession. In the end, the global financial market vetoed the policy by making it very expensive for the Swedish state and effectively forced the krona to float. In the decision to defend the currency, the limited global awareness came to constrain policy options severely.

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[144] See, for example, Torben M. Andersen, "Disinflationary Stabilization Policy – Denmark in the 1980s," in *Exchange Rate Policies in the Nordic Countries*, ed. Johnny Åkerholm and Alberto Giovannini (London: Centre for Economic Policy Research, 1994), 123; Huber and Stephens, *Development and Crisis of the Welfare State*, 262-5.

[145] Wästberg, *Det tomma rummet: Om politikens vanmakt [The Empty Room: On the Powerlessness of Politics]*, 33.

[146] Jonung, "Den finansiella revolutionen," 39.

[147] Hamilton and Rolander, *Att leda Sverige in i krisen*, 107.

In the two other decisions, the policymakers showed more appreciation of both their capabilities and environment, and this improved their chances of policy success. The broad political coalition is a prime example on how the government and Social Democratic opposition realized that their audience was global rather than domestic. In order to reassure the global financial market, the broad national consensus was crucial in buying the government time for reform.[148] The same goes for the decision to support the banks and the measures used to do so. For example, the government made a distinct information effort targeting both domestic and global financial market actors.[149] The external effort included frequent visits of cabinet ministers and officials to all the major financial centres informing a global audience of the measures taken.[150] However, in supporting the banks most of the measures had to be improvised as a consequence of the insufficient formal framework guiding the policymakers.[151]

In sum, the constraints that globalization imposed on policymakers in the Swedish financial crisis were strengthened by the limited global consciousness among policymakers. Global awareness was at a formative phase among the political elite. To the degree that the Swedish government was or became globally aware, it was able to influence the impact of global constraints by re-evaluating and adapting policies to the new environment. However, due to the fact that the government missed the opportunity to realign the currency in coordination with its major trading partners, this extreme policy choice allowed the global financial markets to compromise Swedish political autonomy.

6.4. Conclusion

This chapter aimed to identify and analyse global constraints that impacted upon policymakers in the Swedish financial crisis. The analysis found that there were both material and ideational constraints operating in the key decisions of the crisis. During the crisis, the material constraints emanated from the behaviour of the global financial market, the widening resource gap between the financial markets and the government, and global and regional institutions. The ideational constraints, on the other hand, emanated from the neoliberal policy consensus and the lack of global awareness.

Although the analysis identified global constraints as operative in the crisis, it is very difficult to measure the extent that global constraints impacted on policymakers in the key decisions. This pertains in some degree to the methodological difficulty of getting policymakers to attribute what they could not do and why, rather than what they could do. Policymakers tend to focus on solv-

148 Andersson, "Utformningen av inflationsmålet," 232.
149 Andersson and Viotti, "Managing and Preventing Financial Crises,": 89.
150 Ingves and Lind, "The Management of the Bank Crisis – In Retrospect,": 8.
151 Andersson and Viotti, "Managing and Preventing Financial Crises,": 86.

ing problems, rather than dwelling on what holds them back and to what extent. The combination of the global constraints identified certainly has an impact on policymakers, but the impact is both indirect and diffuse. At best, the evidence in this chapter indicates a direct cause and effect relationship in the extreme circumstances of defending the currency. Consequently, the determinism of the structural approaches, i.e. 'the powerless state' and 'the forced-state adaptation' approaches, is difficult to back up with empirical evidence even in a hard case such as the Swedish financial crisis.

Instead, the evidence in this chapter suggests that global constraints vary over time and circumstances. Rather than being constant, the constraints wax and wane. In the crisis, the impact of the global constraints varied in the different key decisions. As the crisis became more acute, the global constraints increased on the policymakers, but never to the extent that they became powerless. Global finance could force policymakers into action and overturn decisions, but not decide what policy option to pursue. Although the policy options narrowed in the crisis, the policymakers still kept the policy choice.

Global constraints on policymakers were the strongest and most noticeable in the decision to defend the currency. The extreme policy to defend an overvalued currency despite the European financial turmoil and a fundamentally weak Swedish economy invited speculation on the devaluation of the krona. Although policymakers put up a valiant effort to hold the currency, they finally had to surrender and let the krona float. The global financial market vetoed and overturned the fixed currency policy, and thereby impeded Swedish policy autonomy.

In the decisions to support the banks and build a political coalition, the global constraints were less severe. In the decision to support the banks, the policymakers waited as long as possible to take action, but in facing a collapse of the payment system the government was forced to launch measures that had been prepared in advance and were directed both toward a domestic and global audience. The crisis management effort in the banking crisis turned out to be successful in the end. In the decision to build a political coalition, the external threat posed by the global financial market facilitated the actual agreement between the government and Social Democratic opposition.[152] At the height of the crisis, the pressure of the global financial market was strong enough to bring the political adversaries not only to negotiate, but also agree to take measures extending the defence of the krona and launch the bank support.

The impact of global constraints is related to the context and behaviour of the actor. Consequently, rather than being constant features of the global financial system, the global constraints on the state vary with circumstance, perception, and response of the state. Thus there are firm global constraints on extreme behaviour and policies, whereas most policies are either ignored or only

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[152] Stern and Sundelius, "Sweden's Twin Monetary Crises of 1992,": 39.

noticed in the global financial markets. As Mosely argues, "in the advanced capitalist democracies, market participants consider key macroeconomic indicators, but not supply side or microlevel policies."[153] In that respect global constraints can veto certain policies in the right circumstances, but states still have sufficient manoeuvrability to shape the circumstances in the first place and thereby direct their own destiny.

During the Swedish financial crisis, the government and state apparatus had yet to make the necessary policy adaptations to operate in a deregulated and restructured environment where actors other than the state had gained influence, new interconnections mattered, and policymakers had less direct command and control of the domestic economy. The welfare system had managed to shelter the Swedish population from the sudden shifts in the global economy. The financial crisis came to heighten the awareness of the boundaries and constraints that the global economy imposed on the state.

This chapter has deliberately focused on the global constraints on the Swedish state during the financial crisis in order to assess their impact. The following chapter will complement this analysis with an analysis of the policy options and choices of policymakers despite these global constraints.

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[153] Mosley, *Global Capital and National Governments*, 305.

Chapter 7: Policy Options and Choices in the Swedish Financial Crisis

7.1. Introduction

This chapter addresses the issue of state agency in the Swedish financial crisis. While the previous chapter analysed the global constraints on the state, this chapter turns the question around and analyses the options for the state to respond given these constraints. More specifically, faced with the specific global constraints identified and analysed in the previous chapter, this chapter explores the room for state agency in the Swedish financial crisis of the early 1990s.

The financial crisis presented policymakers with a crisis situation shaped by volatile global financial flows that they had not experienced before. As a result, they were slow to perceive the full width of the crisis. As Hay points out, "the complex configuration of constraints and opportunities that a context presents to a given strategic actor – are temporally and spatially specific."[1] This makes it difficult, not to say impossible, for the actors to have perfect information of the environment and understand the full consequences of their actions. We can assume that the policymakers in the financial crisis did not operate on perfect information. Although the policymakers in the Swedish financial crisis were both reflexive, strategic and oriented their policies toward the environment, they had at best only a partial understanding of the environment to inform their policy choices. However, we can also assume that the understanding of the environment evolved and improved as the interaction between the government and the global financial market developed and policymakers assessed their past policy choices.

The argument and perception of diminishing state agency has attracted a lot of academic attention and debate since the early 1990s. The reasoning has varied from being a structural consequence of the unrelenting forces of globalization to claims of an intentional governmental strategy of 'depoliticising' economic management and presenting a 'logic of no alternative' in order to implement preferred policies.[2] However, this is not an uncommon phenomenon. For

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[1] Colin Hay, "Globalisation as a Problem of Political Analysis: Restoring Agents to a 'Process without a Subject' and Politics to a Logic of Economic Compulsion," *Cambridge Review of International Affairs* 15, no. 3 (2002): 381.

[2] See, for example, Burnham, "The Politics of Economic Management in the 1990s,"; Susan Strange, *Mad Money: When Markets Outgrow Governments* (Ann Arbor, MI: The University of Michigan Press, 1998); Matthew Watson and Colin Hay, "The Discourse of Globalisation and the Logic of No Alternative: Rendering the Contingent Necessary in the Political Economy of New Labour," *Policy & Politics* 31, no. 3 (2003).

example, as Holsti pointed out long before globalization was on the agenda, "one way to cope with decision stress is a form of bolstering, attributing to the adversary sole responsibility for choices and outcomes, while absolving oneself, owing to the absence of real alternatives."[3] Whether governments in many industrialized countries were structurally forced to or purposefully pursued certain strategies, the perceived outcome was that governmental manoeuvrability has diminished or even disappeared. Nonetheless, this chapter argues that despite the impact of global finance during the financial crisis, the Swedish government had options and capacity to respond to global pressures. Rather than global finance directing the government in one direction or another, the government had alternative policy options in its key decisions to support the banks, defend the currency, and build a political coalition. However, the different policy choices of the government had varying success rates depending on the government's consideration of the operation of the global financial market and its own capacity after deregulating the Swedish financial market. While the decision to build a broad political coalition successfully facilitated the other decisions, the government managed the banking crisis successfully, whereas the defence of the currency failed. The failure in the defence of the currency was primarily a consequence of misinterpretation of the global financial market, overconfidence in the government's own capabilities to counter the market sentiment, and inflexible crisis management measures.

The financial crisis constitutes a hard case in the sense that one would expect the global financial constraints on the state to be at their strongest because both volatility and profit opportunities draw the attention of global financial market actors. At the same time, the domestic financial problems escalating into a financial crisis pronounce the internal weaknesses of the state that failed to avoid or manage the domestic financial problems in the first place. Therefore, the expectation would be that the financial crisis severely circumscribes the manoeuvrability of the state. In other words, heightened structural pressure on the state and diminished state agency both for internal and external reasons make the financial crisis an important case for studying the potential impact of global finance on the state. While the previous chapter found that the behaviour of the global financial market, the widening gap between resources available to governments and those aggregated in the global financial market, the lack of global institutions, the attractiveness of membership in the institutional framework of the European Community, and the prevalence of neoliberal ideas constrained Swedish policymakers during the financial crisis, this chapter will analyse whether the policymakers had any options to act within these constraints.

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[3] Ole R. Holsti, "Theories of Crisis Decision Making," in *Diplomacy: New Approaches in History, Theory, and Policy*, ed. Paul Gordon Lauren (New York, NY: The Free Press, 1979), 116.

With regard to the conventional approaches identified in chapter 1, this chapter challenges both the structure-oriented perspectives and the agency-oriented ones in order to further develop the suggested constrained-choice approach. On the one hand, the structure-oriented perspectives, the powerless state and the forced-state-adaptation approaches, claim that global structures constrain the state to the extent that it has to act in a certain fashion, i.e. the global structure determines the agency of the state. The agency-oriented perspectives of business-as-usual and policy choice for the state, on the other hand, respectively claim that globalization is either insignificant or that the state still has most of its options available, i.e. the structural feature of globalization has no or very limited impact on state agency.

Rather than giving primacy to either structure or agency, the focus of the constrained-choice approach suggested in this dissertation is on the continuous interaction and dynamic between structure and agency. For example, the rise of global finance is perceived as a consequence of state agency that came to increase the impact of the structure on the state, but states adapt and develop to manage this impact which in turn has an impact on and changes the structure again in a continuous feedback loop. Structure and agency are in a symbiotic relationship and only artificially separable. In drawing on either structure or agency, the conventional approaches provide a lopsided understanding of what is going on in the global economy. As Lebow puts it, "The theory-building endeavor has a strong bias toward deterministic explanations and on the whole downplays understandings of outcomes as the products of complex, conjunctional causality."[4] The constrained-choice approach attempts to take both structure and agency into consideration for a more nuanced and useful understanding of the impact of global finance on the state.

The organization of this chapter is as follows: the first section analyses the options available in the key decisions of the financial crisis. The following sections analyse the policy choices Swedish policymakers made in response to the financial crisis in the decisions to support the banks, defend the currency and build a political coalition respectively. The last section concludes the chapter.

7.2. Policy options in the key decisions of the Swedish financial crisis

This section analyses the three key decisions in relation to the global constraints proposed in the previous chapter in order to discern if and to what extent there were policy options available to the policymakers given these constraints. The global constraints identified in relation to the Swedish financial crisis in the previous chapter are the behaviour of global financial markets, the widening gap between resources available to policymakers and those aggregated in the global

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[4] Lebow, "What's So Different About a Counterfactual?,": 558.

financial market, the lack of global institutions, the attractiveness of membership in the institutional framework of the European Community, and the prevalence of neoliberal ideas. These global constraints came to influence and constrain Swedish policymaking to varying extent in the three key decisions of the financial crisis. The impact of global constraints increased as the financial crisis deepened and policymakers failed to adapt policies to counteract the development and defend its policy space. This section will analyse the policy options in each of these decisions.

The decision to support the banks

The banking crisis developed over a longer period of time and, as with most crisis situations, the options regarding support of the banks narrowed as the crisis worsened. Without taking the global constraints into consideration there were a number of options available to the government in its decision to support the banks. The government could either refrain from supporting struggling banks or support them, and if deciding to support the banks come up with a range of measures ranging from limited to full support of the banks.[5] These options are coherent with the strategies for restructuring financial institutions in distress suggested by the BIS: forbearance, liquidation, and restructuring.[6] Forbearance involves the relaxation of supervisory and regulatory standards to let the banks continue their operation, although they are technically insolvent. This is only a temporary measure of buying more time and the risk is that relaxation of supervision etc. facilitates imprudent behaviour in the banks. Liquidation is the straightforward dismantling of the bank in financial distress and a rather unusual procedure, whereas restructuring of the banks' balance sheets is more common. Restructuring may involve infusion of capital, guarantees, mergers, acquisitions, or negotiating a reduction of the claims of creditors to the bank. In the Swedish case, the choice fell on supporting the restructuring the banks in distress.

Both the exiting Social Democratic government and the centre-right coalition that entered government in October 1991 regarded state intervention as a last resort when the first signs of a banking crisis began to emerge in the fall of 1990.[7] As late as in the summer of 1991, the Social Democrats had presented a positive view of the situation for the banks. The Minister of Finance Allan Larsson claimed that the banks had learnt their lesson with the failing finance companies and that the Bank Supervisory Authority further had strengthened its

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[5] Estrella identifies twelve tools for central banks dealing with financial instability. See Arturo Estrella, "Dealing with Financial Instability: The Central Bank's Tool Kit," *Sveriges Riksbank Economic Review*, no. 2 (2001).
[6] Bank for International Settlements, *63d Annual Report*, 176-7.
[7] Larsson and Sjögren, *Vägen till och från bankkrisen*, 141.

control by increasing the demands on the banks' capital adequacy ratio.[8] However, when the centre-right coalition entered government they got informed by the Social Democrats about the problems in Nordbanken and eleven independent savings banks.[9] Both governments operated on the principle that the banks should take care of themselves and saw no reason to set up a bank support authority or lend limited support to the banks.[10] Still, the state had to secure the operation of the payment system and one of the first tasks of the new government was to consider the management of the crisis-ridden Nordbanken.[11]

After the ad hoc measures to rescue Nordbanken and Första Sparbanken in the fall of 1991, the Ministry of Finance began considering options for a situation where the position of the banks would deteriorate further. As the workload increased, the government signed a contract with McKinsey, a consulting firm, in the end of February 1992 concerning assistance with risk analysis and evaluation of different policy measures in the progression of the banking crisis.[12] Towards the public, the government argued that the support of Nordbanken and Första Sparbanken had been strictly in the role of owner and to secure the stability of the financial system and that they would not issue any general support of struggling banks.[13] At the same time and throughout the spring of 1992, the discussions on what measures to take intensified within the government. For example, already in March 1992 in preparation for a meeting with the government, Bo Lundgren makes the assessment that the government must, without expressing it in public, take full responsibility for failing banks when all other options have been tried.[14]

As the banking crisis continued to deepen, however, the government had to take further measures to maintain the stability of the financial system. It was only when Gota AB, the owner of Gota Bank, went bankrupt on September 9, 1992, that the government began dealing with the situation as a threatening systemic crisis.[15] The options considered included the state acquiring banks' bad debt, setting up some sort of insurance to curb credit losses, setting up an authority to manage the support of the banks, but the government did not want to take the banks into state ownership. In September 1992, Urban Bäckström, under secretary at the Ministry of Finance, admitted in the Financial Times that

[8] See Minister of Finance Allan Larsson's speech (anf. 24) in the parliament. Sveriges Riksdag [The Swedish Parliament], "Protokoll [Record of Proceedings] 1992/93:31, November 25," (http://www.riksdagen.se/debatt/protokoll/index.asp, 1992).
[9] Lundgren, *När bubblan brast*, 18.
[10] Larsson and Sjögren, *Vägen till och från bankkrisen*, 141.
[11] Lundgren, *När bubblan brast*, 21.
[12] Ibid., 87.
[13] Bo Lundgren, "Vi räddar inga banker [We Will Not Save Any Banks]," *Dagens Nyheter*, 11 April 1992.
[14] Lundgren, *När bubblan brast*, 101, 339-43.
[15] Englund, "The Swedish Banking Crisis: Roots and Consequences,": 91.

the state had to prepare for a "worst-case scenario" and pursue a "comprehensive strategy 'taking a whole grip of the banking system'."[16]

The government had continued to publicly take the neoliberal position that the state would guarantee the payment system, but not save the owners of the banks.[17] The market forces would rule and let the strong banks survive, while the weak would perish. However, as the banking crisis deepened with the high interest rates in defence of the currency, the problem with this approach had materialized: What was the government to do if all banks failed? The Swedish banks were few, large and had different kinds of problems, and that forced the government to set up general principles but also allow flexibility in the support of the banks. These principles were to limit the support and let the banks pay back as much as possible from future profits, the conditions for support would minimize subsidies, all banks would have the opportunity to apply for support as long as they fulfilled the conditions, and state ownership would be minimal.[18] On September 24, 1992, the government announced its proposition to the Parliament to strengthen the payment system and secure credit supplies, and it included a state guarantee to safeguard depositors and creditors to Swedish banks and an authorization to take measures to secure the payment system without the Parliament voting on every decision.[19] Although it took three months for the proposition to go through Parliament, the announcement instantly improved the confidence in the payment system.

In sum, for a long time the government had options in supporting the banks despite global constraints. However, as the crisis progressed the options narrowed and finally the preferred course had to be abandoned. Economic realities and practicalities took precedence over ideological preferences. Section 7.3 will analyse why the government decided on the specific options of supporting the banks and setting up a bank support authority.

The decision to defend the currency

The options for the government regarding the decision to defend the currency were ultimately a decision on Sweden's exchange rate regime. From a general economic theory point of view, there is no prevailing economic argument for an optimal exchange rate policy. There are advantages and disadvantages with both fixed and floating exchange rate regimes. Instead, it becomes a political issue to decide what set of implications is preferable.[20] For example, as Frieden

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[16] Robert Taylor and Sara Webb, "International Company News: Sweden Draws up Contingency Plan to Bail Out Banks," *Financial Times*, 12 September 1992.
[17] Per Afrell, "Banksystemet på väg mot total kollaps [Banking System Heading Towards Total Collapse]," *Dagens Nyheter*, 13 September 1992.
[18] Lundgren, *När bubblan brast*, 148.
[19] Robert Taylor, "The ERM and Maastricht: Sweden Acts to Shore Up Shaky Financial System," *Financial Times*, 25 September 1992.
[20] Broz and Frieden, "The Political Economy of International Monetary Relations,": 319.

points out, the fixed exchange rate prioritizes stable exchange rates before political influence over the domestic price level and this is attractive to export-oriented producers and international investors and traders that are sensitive to exchange rate volatility and relatively indifferent to the domestic macroeconomic situation. Flexible or floating exchange rates, on the other hand, are attractive to producers of nontradable goods and services and producers of goods for the domestic market competing with imports, who are relatively dependent on national policymaking autonomy and independent to exchange rate volatility.[21]

Sweden had pursued a fixed exchange rate policy since the massive devaluation in 1982 with a stricter unilateral peg to the ECU from May 1991.[22] Although the fixed exchange rate was preferred by the whole political spectrum at the time of the crisis, there were of course other options and arrangements available. In general, the government has the option either to follow a fixed or a floating exchange rate regime. Then, if the government decides on a floating regime, it can either let the currency float freely, i.e. without intervention, or set a target range, i.e. managed float. If the government sets a target range, it can either opt for a strong or weak currency letting the relative value of the currency appreciate or depreciate.[23]

The Swedish government had the same options during the financial crisis. In its key decision on defending the currency, the alternative options to defending the fixed exchange rate were to let the currency float freely or realign it at a new level or to some other currency or currency basket. However, the government and opposition had decided to have a fixed currency and then over the years failed to follow policies that make this sustainable. As two officials of the Riksbank, Thomas Franzén and Kerstin Mitlid, argue, it became "impossible to maintain the confidence in the fixed-exchange rate regime when the adjustment requirements had been allowed to become too great. Political support for the fixed-exchange rate system did not suffice, since the system had not been linked to an economic policy compatible with a fixed-exchange rate."[24] Despite the deregulated capital market, Sweden wanted both national policy autonomy and exchange rate stability, and this is incongruent with the so-called Mundell-Fleming framework that argues that the government has to choose between either national policy autonomy or exchange rate stability when capital is mobile.[25] In letting the macroeconomic situation deteriorate to the extent that there

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21 Jeffry A. Frieden, "Invested Interests: The Politics of National Economic Policies in a World of Global Finance," *International Organization* 45, no. 4 (1991): 444-5.
22 Jonung, *Looking Ahead*, 204.
23 Broz and Frieden, "The Political Economy of International Monetary Relations,": 318-9.
24 Franzén and Mitlid, "A Swedish Perspective," 273.
25 Cohen, "The Triad and the Unholy Trinity,"; J. Marcus Fleming, "Domestic Financial Policies Under Fixed and Floating Exchange Rates," *IMF Staff Papers* 9 (November) (1962);

was no credibility in the currency constituted something of a democratic paradox. The voters wanted a fixed currency, high employment and measures that fuelled inflation at the same time and this was impossible for the government to provide.

The government and Riksbank also had a range of options in the practical defence of the krona. As Mosely points out, "a government that finds itself subjected to capital or exchange market pressures may accede to the pressures, resist the pressures, or redefine the nature of its relationship with international markets."[26] These options were also open to the Swedish government and it began resisting the pressures, then had to accede to the pressures, and finally had to redefine its relationship with international markets. In deciding to resist the pressures the government had a range of measures at their disposal and it had to decide on the best mix of measures to use and the timing of their implementation. For example, the government employed a mix of interest rate hikes, market intervention, crisis packages, communications strategies etc. in the crisis management effort in order to extend and hopefully prevail in the defence of the krona. Until the currency was forced to float, the government made a strong effort to give market actors and the public the impression that there were no alternatives to the fixed currency and that devaluation of the currency was ruled out. For example, Anne Wibble, tried to increase the credibility of the policy after the Riksbank had hiked the interest rates in September 1992 and stated that "the fixed exchange rate of the krona is the most important cornerstone of our entire economic policy….We will do what it takes to convince the outside world that we are not going to devalue."[27] While the government did what it could to resist the pressures on the fixed currency and limit public debate on alternative currency arrangements, it considered alternative options internally. The government was very concerned about anything that might imply that it was swerving from its chosen policy option of defending the krona. For example, in an op-ed analysis of the situation and options available for the government the chief economist at Nordbanken, Nils Lundgren, argued that devaluation was preferable to continuous high interest rates and this upset representatives of the government to the extent that they refused to be seen in public together.[28] From the government's perspective, the concern was that the analysis could be interpreted as a lack of unity and determination in the defence effort

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Robert A. Mundell, "Capital Mobility and Stabilization Policy Under Fixed and Floating Exchange Rates," *Canadian Journal of Economics and Political Science* 29, no. 4 (1963).

[26] Mosley, *Global Capital and National Governments*, 198.

[27] Quoted in Robert Taylor and Sara Webb, "Swedish Money Rate Hits 75%," *Financial Times*, 10 September 1992.

[28] Nils Lundgren, "Kronans fall nära [The Fall of the Krona Is Nigh]," *Dagens Nyheter*, 28 September 1992; Lundgren, "Per aspera ad astra - Sveriges väg till samhällsekonomisk balans [Per Aspera Ad Astra: Sweden's Road to Socio-Economic Equilibrium]," 384.

since it came from a representative of a state-owned bank.[29] Although the government in public firmly promoted the defence of the currency, there were considerations of alternative policy options. For example, in September 1992, the Ministry of Finance analysed the consequences of devaluation coming to the conclusion that Sweden should not devalue its currency, and in the Prime Minister's office, Carl Bildt's economic policy advisor Professor Lars Jonung leaned towards leaving the fixed currency.[30] There was also contingency or alternative planning in the Riksbank. However, they focused primarily on measures within the fixed currency framework, such as fixing the currency to the EMS or the German Mark.[31] In this respect, alternative options were analysed and considered, but the political and bureaucratic elites stuck to the decision to defend the currency.

In sum, the focusing on and promoting the option of defending the currency the government constrained its available choices and as the crisis worsened it became more and more difficult to back away from the chosen path. However, there were options available to the policymakers both with regard to exchange rate regime and the measures employed to defend the currency. Section 7.4 will analyse why the government decided on the specific option of defending the currency.

The decision to build a political coalition

The decision to build a political coalition is intrinsically connected to both the decisions to support the banks and to defend the currency. Without the decision to defend the currency and subsequently the banks, there would not have been a coalition. However, the confluence of the banking and currency crises in time had created sufficient pressure on the government to postpone political battles and constructively negotiate two crisis packages with the Social Democratic opposition in order to defend the fixed currency and reform the Swedish economy.

The political coalition managed to put together two crisis packages and sustain the crisis management effort for almost two months. It was not until the Social Democrats refused to negotiate a third crisis package that the coalition broke down and the krona was forced to float.[32] According to Ingvar Carlsson, it was no longer justifiable to spend more resources on holding the currency and the patience in the labour movement was running out.[33] When the unprecedented peacetime political coalition broke down, Swedish politics returned to

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[29] Phone interview with Olle Wästberg, 2004-03-17.

[30] Hamilton and Stuart, "I stormens öga," 119-20; Jonung, "Den finansiella revolutionen," 49.

[31] Dennis, *500%*, 198, 287-8.

[32] Robert Taylor and James Blitz, "Sweden Floats Krona after Outflow Threatens Reserves," *Financial Times*, 20 November 1992.

[33] Carlsson, *Så tänkte jag*, 502.

normal. However, the political elite had in action proven that they jointly could influence the market sentiment of the Swedish economy at least temporarily. After the failure to defend the fixed currency, Carl Bildt stated in Parliament:

> For the government, it was natural to seek cooperation with the largest opposition party. And the crisis packages that were negotiated during the fall were of great importance. They show that the political parties in critical situations can let national interests take precedence to tactical party decisions.[34]

Although the political effort to hold the currency failed, it is also showed that policymakers can make a difference and influence the financial market sentiment. It is the political willingness and capability to bear the costs of defying the financial market sentiment that decides how long policymakers can resist.[35] Consequently, there are alternative policy options available and political choices have different consequences.

Although the government reluctantly tested the ground for political compromises primarily with the Social Democrats, but also with Ny Demokrati, the government publicly downplayed the financial crisis for as long as possible hoping that a political coalition would be unnecessary.[36] In so doing, the government chose the policy option of inaction. It was first when the Riksbank had increased the marginal overnight interest rate to 500 percent and the crisis become acute that the option of refraining from policy measures altogether effectively fell away.[37] Decisive and immediate political measures were needed to bring down the interest rate or the krona would have to depreciate.[38] With the ambition of the government to hold the currency peg to the ECU still intact, the government had to launch measures to diminish the pressure on the currency. According to Carl Bildt, the government had to convince the financial markets of its policy intentions and win time for the policy process to run its course.[39]

The government had a number of policy options to address the deepening financial crisis. Firstly, the government could take policy measures to defend the currency and support the banks alone, i.e. refrain from building a political coalition. Although the minority government preferred a parliamentary major-

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[34] Sveriges Riksdag [The Swedish Parliament], "Protokoll 1992/93:31,". My translation.
[35] For similar arguments, see Benjamin J. Cohen, "Marketing Money: Currency Policy in a Globalized World," in *Coping with Globalization*, ed. Aseem Prakash and Jeffrey A. Hart (London: Routledge, 2000), 188; Pauly, "Capital Mobility, State Autonomy and Political Legitimacy,": 373.
[36] Teorell, "Demokrati eller fåtalsvälde?", 86 n. 23.
[37] Still on September 8, 1992, the Minister of Finance expressed in a press conference that there would be no crisis package regardless of how much the interest rate went up. See Ewa Stenberg, "Wibble öppen för kompromiss. Inga krispaket [Wibble Open for Compromise. No Crisis Packages]," *Dagens Nyheter*, 9 September 1992.
[38] Dennis, *500%*, 54.
[39] Bildt, "Den stapplande vägen till reformer och till Europa," 66.

ity backing its measures, it was very unlikely that SAP and Ny Demokrati jointly would topple the government in the severe crisis situation both for ideological reasons and because they would have inherited the responsibility to manage the crisis. According to Carl Bildt, the parliamentary uncertainty influenced the credibility of the economic policy negatively and therefore there was much to gain especially in the short-term from assembling a parliamentary majority.[40] The government had also made clear that it was striving for a broad parliamentarian support of its policies and invited all other parties to unconditional discussions of measures on September 14, 1992.[41]

Secondly, the government could pursue a coalition with the right-wing populist party Ny Demokrati (New Democracy). Ny Demokrati had already in late August invited the government to negotiate a package solution to come to terms with the budget deficit.[42] Although the government saw Ny Demokrati as unreliable, both Carl Bildt and Anne Wibble wanted to maintain contact with Ny Demokrati in case their support became necessary.[43]

Thirdly, the government could approach the Social Democratic opposition and agree to form a political coalition. At least some in the minority government saw this option as preferable to cooperating with Ny Demokrati. As Anne Wibble said, "The Social Democrats have more political stability. However, an agreement can only be reached if it contains the right policies."[44] According to Bengt Westerberg, the government believed that gaining the credibility of the financial market would require broader support than Ny Demokrati could provide, which meant that the Social Democrats were the only suitable partner.[45] This belief coincided with the interpretation of the market sentiment made in the Financial Times in late August arguing that the markets saw the Ny Demokrati as unreliable. Rather than the downfall of the government, the markets wanted the government to follow the Danish approach and settle upon "a broad economic agreement across the parliamentary spectrum, including the opposition Social Democrats."[46] Not only would an agreement with the SAP mean a broader and more reliable majority in Parliament, but hopefully also

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[40] Ibid., 63.
[41] Hamilton and Stuart, "I stormens öga," 125.
[42] Magdalena Ribbing, "NyD vill förhandla om åtgärdspaket [NyD Wants to Negotiate Policy Package]," *Dagens Nyheter*, 28 September 1992.
[43] Hamilton and Stuart, "I stormens öga," 129; Teorell, "Demokrati eller fåtalsvälde?", 56. Carl Bildt's remark dates to September 18, 1992, the same day formal negotiations with SAP commenced. Anne Wibble's remark dates to September 16, 1992. However, Bildt claims that the government for factual and symbolic reasons never considered the alternative of negotiating with Ny Demokrati. See Bildt, "Den stapplande vägen till reformer och till Europa," 63.
[44] Stenberg, "Wibble öppen för kompromiss. Inga krispaket [Wibble Open for Compromise. No Crisis Packages],".
[45] Interview with Bengt Westerberg, 2004-02-26.
[46] Robert Taylor, "Sweden Gripped by a Crisis of Confidence," *Financial Times*, August 27 1992.

send the impressive signal to the financial market that the Swedish political system was ready to unite despite ideological disagreements and produce policy measures to manage the crisis. As Carl Bildt told the Financial Times after negotiating the first crisis package, "A few weeks ago I saw severe troubles in Parliament on economic policy. Now we will have a comfortable majority for what needs to be done."[47]

In sum, the constraints on the government were not firm enough to leave it without options to pursue in managing the crisis. At the same time, the extraordinary circumstances demanded extraordinary measures to manage the situation. In sum, there were options available in the decision to build a political coalition and these options were constrained as the financial market pressure on the Swedish economy increased. For example, the government waited to take action until it was absolutely necessary in order to defend the currency. Like all negotiations, the crisis packages were compromises and the measures were based on the participants' interpretations and expectations of what the financial markets would react favourably towards and what the electorate would tolerate. To that extent, the negotiations of the crisis packages were constrained in that the proposed policy measures had to respond to the perceived demands of the global financial market, i.e. the policy measures had to be significant enough to have an impact on the financial market and bring down the interest rate. At the same time, the participants in the negotiations had to take the coming assessment of the electorate and their respective party organizations into consideration when agreeing on measures. Despite these constraints, the participants in the negotiations had multiple options in agreeing on what measures to take and how to communicate their policies to the market.

Although the government was constrained to some extent in the three decisions, they had different options available. This reconfirms Gourevitch claim that "however compelling external pressures may be, they are unlikely to be fully determining, save for the case of outright occupation. Some leeway of response to pressure is always possible, at least conceptually." [48] The following sections will analyse why the government settled on a specific policy response among the competing alternatives.

7.3. Policy choice in the decision to support the banks

The previous section argued that there were options available to the policymakers and that they actively considered and prepared different approaches to sup-

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[47] Robert Taylor, "The ERM and Maastricht: Sweden Unties Welfare Apron Strings - The Price to Be Paid in Adapting to New Realities," *Financial Times*, 23 September 1992.
[48] Peter Gourevitch, "The Second Image Reversed: The International Sources of Domestic Politics," *International Organization* 32, no. 4 (1978): 911.

port the banks during the banking crisis. However, as the crisis developed the range of policy options narrowed. This section will analyse why the policymakers choose to support the troubled banks despite the government's ideological predilection to avoid state intervention, let the market forces decide what companies would survive and to privatize, rather than further nationalize companies. There are three factors that stand out in their motivation to finally support the banks: 1. the immediate necessity to stabilize the payment system (measures were necessary to build credibility, economic implications of bank failure); 2. the lack of preparedness (lack of awareness of severity and consequences of bank failure, no regulations or experience to fall back on promotes ad hoc approach); 3. the environment that the banks and policymakers operated in made action precarious –(the rise of global finance and deregulation had changed the environment and the banks had not been cautions in their lending, action may trigger counter-actions that cancel or worsen the effect of the initial measure).

Threat of systemic crisis

When the financial crisis deepened in the early fall of 1992, the threat of a systemic crisis increased to the extent that the government had to act in order to avoid a bank panic and secure the stability of the payment system. The conjunction of the banking and currency crisis both necessitated and facilitated a response from the government, and the acute systemic threat forced the government to leave its ideological predilection to refrain from supporting the banks. The government had downplayed the problems in the banking sector and hoped that they would go away[49], but with the acute systemic threat it could not wait any longer to support the banks. In the Financial Times, the correspondent pointed out that "it is, of course, something of an embarrassment for the country's centre-right coalition, which as espoused free-market principles, to have to mount such a bail-out."[50]

Instead of intervening proactively to support the banks, the government had waited as long as possible and until the banking crisis had taken system-threatening proportions before implementing measures to support the banks and banking system. In September 1992, Urban Bäckström, under secretary of finance, confirmed that "we have reached a point where the whole banking system seems to have severe problems. If we don't take precautions we might end up with all the banks being state-owned"[51] According to Bo Lundgren, the Minister of Banking and Taxation, the government waited to launch its support,

[49] This is the equivalent to what Katzenstein calls the Peter Pan approach to public policy (if you close your eyes and wish really hard…). Katzenstein, *Small States in World Markets*, 210.
[50] Christopher Brown-Humes, "Sweden Erects Banking Defences: A Look at a Package of Support Measures," *Financial Times*, 13 November 1992.
[51] Sara Webb, "Sweden's Banks Face a Legacy from the 1980s: Sara Webb Analyses Problems Facing the Centre-Right Government over the Troubled Banking Sector," *Financial Times*, 14 September 1992.

because it wanted to minimize the risks of moral hazard among the banks and force the owners of the banks take as much responsibility of the banks restructuring effort as possible.[52] Critics of bank support often point out that the support may lead to good money being thrown after bad, and that it stimulates bad lending practices and disrupts competition among the banks.[53] The government had followed the same line of reasoning and refrained from supporting the banking system until the threat to the banking system had become imminent.

In the end, the risks of forced nationalization of the financial system had outweighed the risks of moral hazard on the strategic level. However, considerations of moral hazard still mattered on a tactical level. For example, in deciding on whether to support only individual banks or the whole banking system, the government decided to support the whole system because individual support could have disadvantaged solvent banks to the extent that they would have to be supported too and thereby forced a general guarantee to be implemented at a later point in time.[54] In order to counter the systemic threat, the government with the backing of the Social Democratic opposition settled on the resolute decision to issue the general guarantee of the banking system.

Global financial environment

The global financial environment forced the government to be careful and adaptive in its crisis management effort. The banks had not taken the volatile nature of the global financial market into consideration as they rapidly increased their loan stocks in the aftermath of the deregulation. As Viotti puts it,

> The culture of conservatism and prudence in banking circles now went head-to head with a new sales-oriented battle for market share; as real estate prices in particular began to soar, the latter view came to dominate and resulted in loans being granted without sufficient risk assessment and control.[55]

As banking crisis and the systemic threat developed, the government made a strong effort to downplay or refuse to acknowledge the deteriorating situation and tried to shift the public's attention to the specific situation of the troubled banks. For example, in an interview late in May 1992, Carl Bildt's assured that the financial crisis primarily was a problem for Nordbanken and to some extent Första Sparbanken, while the Swedish financial system was fundamentally

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52 Lundgren, *När bubblan brast*, 32.
53 Brown-Humes, "Sweden Erects Banking Defences: A Look at a Package of Support Measures,".
54 Gabriel Urwitz, "Erfarenheter från en bankkris [Experiences From a Banking Crisis]," *Ekonomisk Debatt* 26, no. 1 (1998): 61.
55 Staffan Viotti, "Dealing with Banking Crises – Proposals for a New Regulatory Framework," *Sveriges Riksbank Economic Review*, no. 3 (2000): 48.

sound and the real estate market stabilizing.[56] However, despite public reassurances, the government was ready to intervene and support the banks whenever the threat of a systemic crisis became imminent. Already in March 1992, Bo Lundgren was aware of the deepening and risks involved in a banking crisis, and he realized that it ultimately was the responsibility of the government and the Parliament to secure the operation of the payment system.[57] The difference in the external and internal perception of the crisis would suggest that the government adapted its tactic approach to the developing banking crisis in accordance with the risks present in the deregulated environment.

Although the support of the banks went against the ideological grain of the government, the rise of global finance had changed the environment in which the banks and government operated and increased the threat to the payment system in the form of volatile crossborder capital flows depending on the confidence level of financial market actors in the Swedish economy and political system. International financial market analysts focusing on Sweden regarded the systemic shift proposed by the incoming Bildt government as promising and especially praised the low inflation, the unilateral peg of the krona to the ECU, and the application for EC membership. However, already in the early summer of 1992, they were sceptical about the rising unemployment in Sweden and questioned what rate Sweden could take before devaluing the currency. In doing so, they demanded a premium to invest in Sweden. Despite the risks of devaluation, the high real interest rate, credible Swedish multinational corporations, and coming changes in the law regarding foreign ownership made Swedish securities attractive to foreign financial actors.[58]

The government's credibility among analysts and tactical downplay of the banking crisis worked temporarily to buy the government time to iron out the measures to take in the case of bank failure. However, according to Ingves and Lind, it was the international dimension that made the systemic crisis acute. [59] While Swedish banks were reluctant to accommodate short-term liquidity problems in other Swedish banks in the spring of 1992, actors on the international interbank market continued to provide loans to Swedish banks in trouble.[60] Foreign banks had underestimated the risks in the Swedish banking sector and continued lending to the Swedish banking system also after the credit losses started to grow rapidly. According to Urwitz, it is possible that the credit rating agencies were slow in reassessing the credit risks in Swedish banks as the risks

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[56] Dick Ljungberg and Ewa Stenberg, "Bildt viker inte om karensdagar [Bildt Will Not Fold on Qualifying Period]," *Dagens Nyheter*, 27 May 1992.
[57] See reprinted memo in Lundgren, *När bubblan brast*, 339-43.
[58] Johan Schück, "Svenska papper lockar utomlands [Swedish Securities Attractive Abroad]," *Dagens Nyheter*, 5 June 1992.
[59] Ingves and Lind, "Om att hantera en bankkris,": 44.
[60] Urwitz, "Erfarenheter från en bankkris,": 57.

kept growing.[61] However, with the large foreign loans to Swedish banks, the external confidence in the Swedish banking system was crucial to avoid a systemic crisis and it was when foreign lenders to Swedish banks reduced or withdrew their credit lines that the crisis became acute and threatened the stability of the Swedish financial system.[62] On September 24, 1992, the Swedish financial system was very close to collapse because even foreign creditors had lost confidence in the Swedish banking system.[63] In facing a breakdown of the financial system never experienced before, the government decided that far-reaching state intervention was necessary to avoid it and launched the guarantee that the state would temporarily ensure that banks and certain other credit institutions could meet their commitments.[64] However, in deciding to intervene and rescue the banks, the objective of the government was not primarily to save the depositors in the banks, but to ensure the creditworthiness and credibility of the country.[65] Without intervention the government could have been denied lending and the functioning of the financial system in Sweden would have ground to a halt, with severe societal repercussions and a return to barter trade as potential consequences.

Limited preparations

The deregulated environment that the banks and government operated in also influenced the preparations for the crisis management effort. Although the early warning signals were present, the government had not picked up on the macroeconomic indicators that signalled the build-up of increasing risks and vulnerability in the banking sector between 1985 and 1990. While, for example, bank lending grew faster than GNP and the increasing debt burden of households and the corporate sector could have served as early warning signals, insufficient measures were taken to counter the development.[66] This meant that valuable time was lost in taking proactive measures. The Bildt government that entered in the fall of 1991 took over a fragile banking system and realized the threat of a severe banking crisis in March 1992.[67] The government feared worsening the banking crisis by admitting to their worries and need of policy measures. According to Lundgren, general support measures to the banks in this situation could have been counterproductive in unsettling market actors and decreasing the confidence in the Swedish financial system further.[68] In this envi-

[61] Ibid.: 58.
[62] Ingves and Lind, "Om att hantera en bankkris,": 44.
[63] Ibid.: 45.
[64] Ministry of Finance, *Ending the Bank Support: Ds 1995:67* (Stockholm: Fritzes, 1995), 5.
[65] Phone interview with Olle Wästberg, 2004-03-17.
[66] Felice Marlor, "Macroeconomic Indicators of Systemic Risk," *Sveriges Riksbank Quarterly Review*, no. 1 (1997).
[67] Lundgren, *När bubblan brast*, 18, 339-43.
[68] Ibid., 101.

ronment, proactive and extraordinary measures become difficult to implement without becoming self-fulfilling triggers and this pushes preparations to become secretive.

In an environment demanding secretive preparations, it is difficult to launch comprehensive and resolute countermeasures. Bengt Dennis, the governor of the Riksbank during the crisis, argues for example that neither the Riksbank, the Ministry of Finance, nor the Swedish Financial Supervisory Authority (Finansinspektionen) predicted the severity and scope of the banking crisis. Early on they had seen increasing problems in the financial sector but expected the coming adjustment and restructuring to be calmer and more gradual.[69] This observation might be true on a general level, but there are also examples of situational awareness. For example, Stefan Ingves, in the Ministry of Finance, had with the help of external consultants analysed different scenarios and come to the conclusion that the banking crisis could reach the magnitude experienced in Norway's severe banking crisis and that the crisis would continue to deepen for a few years.[70] While preparations for alternative developments had started in the Ministry of Finance in the spring of 1992, it turned out that the worst scenario they had prepared for was about to happen in the fall of 1992.[71]

Although the Ministry of Finance had half a year to prepare before the acute systemic crisis and the urgency to support the banks materialized, in the early days the crisis management effort was tentative and probing rather than decisive and definitive. Sweden lacked experience of bank failures and the crisis in the early 1990s was the first Swedish financial crisis since the 1930s. In an official statement, the Riksbank concluded that "there are no current Swedish experiences of how the Riksbank should act in case of a bank failure"[72] Since the last Swedish bank failure was in 1905, the lessons had to be learnt from abroad.[73] According to Viotti, "it is beyond dispute that the design and implementation of the government's response to the Swedish banking crisis was improvised without any guiding precedent or regulatory support."[74]

At the Riksbank, there was no hesitation about its role or how to act in the case of bank failure and instability in the financial system.[75] Surprisingly, Bengt Dennis does not see this lack of hands-on experience as a problem and claims that the Riksbank compensated its relative inexperience by studying international cases and the well-developed international literature on the role as

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[69] Dennis, *500%*, 213.
[70] Ingvar Körberg, *Ekluten: Förändringsprocessen inom sparbanksrörelsen 1980-1995 [The Assay: The Process of Change in the Sparbank group 1980-1995]* (Stockholm: Ekerlid, 1999), 262; Lundgren, *När bubblan brast*, 90-1.
[71] Bäckström, "Finansiella kriser – svenska erfarenheter [Financial Crises – Swedish Experiences],": 12.
[72] Quoted in Dennis, *500%*, 214. My translation.
[73] Phone interview with Stefan Ingves, 2004-02-26.
[74] Viotti, "Dealing with Banking Crises,": 50.
[75] Dennis, *500%*, 213.

lender-of-last-resort. With no standard operating procedures to fall back on, the main influences on the thinking and preparations at the Riksbank were the collapse of the Herstatt bank in Germany 1974, the serious problems encountered by the American savings banks (Continental Illinois in 1984) and Norwegian banks (1986) in the 1980s.[76]

In the Ministry of Finance, however, the preparations were more complicated. When the banking guarantee was drawn up, the small and necessarily secretive team of officials in the Ministry of Finance had to start from scratch with no formula to follow.[77] With the first signs of problems in the banking sector, they had put their regular tasks to the side and focused fully on the practicalities of supporting the banks in distress and maintaining the confidence in the Swedish payment system. The unique situation required a unique approach and the team got unusually free hands to come up with a solution to the deteriorating banking situation. According to Ingves, who led the team at the Ministry of Finance, the team got a mandate from Bo Lundgren, Minister of Banking and Taxation, and Urban Bäckström, under secretary in the Ministry of Finance, to buy the knowledge they needed from wherever it was available in the world. In order to find the needed experience in the short time available, the team hired foreign consultants (McKinsey, Credit Suisse First Boston etc.) to gather the best foreign experts on banking crises, brought them all together, 'picked their brains', and applied the information to the Swedish situation. According to Ingves, what has been called the Swedish model to solve banking crises was really a hotchpotch of the experiences from separate bank failures and crises around the world.[78] Consequently, without the preparations, experience, regulations, or standard-operating procedures to fall back on in times of crisis, policy-makers had to devise the measures to support the banks in the midst of a developing crisis and the time needed for this effort further complicated proactive measures.

Once the government had decided to approach the banking crisis as a system-threatening crisis and support the banks with a general banking guarantee, it had to turn its preparatory work into policy. In deciding to support the banks, the government also spread the cost of the support to the whole population. Urban Bäckström told the Financial Times, that "everybody will have to pay for achieving stability as taxpayers and customers."[79] The team devising the rescue operation of the banks in distress had also realized the necessity of a separate authority to manage the situation soon after beginning their work. However, the setting up of a new government body follows a specific legal procedure that

[76] Ibid., 213-4.
[77] Phone interview with Stefan Ingves, 2004-02-26.
[78] Ibid.
[79] Taylor and Webb, "International Company News: Sweden Draws up Contingency Plan to Bail Out Banks,".

takes time to implement.[80] The preparation of the legislation needed to implement the rescue operation of the banks would take until December 1992. In the meantime the government had to do what they could to maintain the credibility of the rescue package. Openness and information were crucial ingredients in the government's strategy to maintain the confidence of the international investors and the public. Viotti argues that that "the tiniest doubt on the part of international investors" could have triggered funding problems for Swedish banks to the extent that it brought down the payment system.[81] The broad political coalition backing the decision to support the banks was also very important to make the crisis management effort credible.[82] In maintaining the confidence in the Swedish crisis management effort, Swedish officials visited all the major financial centres to keep international investors informed. The government hired Credit Suisse First Boston to arrange 'roadshows' to reassure international investors of the development. According to Ingves, it was decisive in these meetings to be forthcoming about what had transpired, the method applied to resolve the situation, the progress made, the measures taken, and the immediate plans for the future in order to build trust with the financial market actors.[83]

In sum, there were different policy options available in the decision to support the banks. The progression of the crisis limited the options available to the government, although they still had leeway in how to design and implement measures in support of the banks. The risks of letting the banks fail or triggering a run on the banks made the government step in to restructure the banks in distress and stabilize the banking system with a banking guarantee, a bank support authority, and infusion of capital. Despite limited preparations, the government searched intentionally and pragmatically for alternatives and best-practices around the world and applied these experiences to the Swedish situation. In doing so, the government applied an adaptive strategy to the banking crisis that accounted for both the global financial market environment and the domestic capabilities to handle the crisis. As the Financial Times wrote in a survey one year later:

> The measures the government took to tackle the crisis – providing a blanket safety net for the entire banking system, encouraging banks to dig their own way out of trouble, using the 'bad bank' formula for problem loans – have proved effective both in maintaining confidence and securing the recovery.[84]

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[80] Phone interview with Stefan Ingves, 2004-02-26.
[81] Viotti, "Dealing with Banking Crises,": 50.
[82] Phone interview with Stefan Ingves, 2004-02-26.
[83] Ibid.
[84] Christopher Brown-Humes, "Survey of Sweden (14): Clear Evidence of Turnaround – The Banking Sector," *Financial Times*, 21 December 1993.

This strategy was a key ingredient in the successful resolution of the banking crisis.

7.4. Policy choice in the decision to defend the currency

Above it was argued that there were options available in the governmental decision to defend the currency. The government could have devalued or floated the currency at an earlier stage and thereby decreased the costs of the failed defence effort and sped up the recovery of the depressed Swedish economy, but instead decided on defending the currency. One alternative scenario could have been to either devalue or depreciate the currency when the other major currencies had to do so. The counterfactual argument could be made that had the Swedish government followed the example of most other European countries suffering in the ERM crisis and let the krona float or realign, it is both plausible and likely that the krona would have followed a similar path without the extensive cost of the defence and an earlier recovery.[85] However, it is impossible to know before the fact whether defending the currency will succeed or not. As Leblang shows, not all speculative attacks on currencies result in devaluation and policymakers defending a fixed exchange rate with access to both sufficient foreign exchange reserves and signalling their ambition may be successful in their currency defence.[86] Nevertheless, the Swedish government both replenished foreign reserves and worked hard on signalling its ambitions in order to successfully defend the currency, but failed anyway.

The decision to defend or realign the currency takes on a very different light whether it turns out to be successful or not, i.e. the rationale for the decision looks very different before and after the fact. Although the many currency crises of the 1990s have led to more studies of the risks involved in currency defence, it is still a highly uncertain endeavour to set out on defending the currency. For example, Eichengreen and Rose come to the conclusion that being involuntarily forced to abandon the fixed currency results in painful and significant output losses and that it usually is better for countries to move voluntarily to greater exchange rate flexibility from a strong currency position than as a result of speculative attacks.[87] This section analyses why the government choose to defend the currency, although there were alternatives that at least in

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[85] See, for example, Nils Lundgren and Hans Tson Söderström, "Kronförsvaret hösten 1992 - Var det värt sitt pris? [The Defence of the Krona in the Fall of 1992: Was It Worth the Price?]," in *Ekonomisk politik - en vänbok till Assar Lindbeck [Economic Policy - Essays in Honor of Assar Lindbeck]* (Stockholm: SNS Förlag, 1995).
[86] David Leblang, "To Devalue or to Defend? The Political Economy of Exchange Rate Policy," *International Studies Quarterly* 47, no. 4 (2003).
[87] Barry Eichengreen and Andrew Rose, *Does It Pay to Defend Against a Speculative Attack?* (Department of Economics, University of California, Berkeley, 2001), 21, Paper available at http://emlab.berkeley.edu/users/eichengr/research/defense8.pdf.

retrospect seem more attractive, and then discusses why the defence went wrong. There are four factors that stand out in the decision to defend the currency. They are the experience and consensus of fixed currency policy, striving for membership in the European Community, underestimation of the severity and scope of the financial crisis, and the distribution of costs for realignment.

Experience and consensus among the political and economic elite

As argued above, there is no straightforward economic argument for one exchange rate regime or another. Instead, preferences and political considerations are important in choosing exchange rate regime.[88] In the Swedish case, a major reason for the decision to defend the krona had its origin in the experience of five devaluations implemented between 1976 and 1982 and the consensus within the political and economic elites that the devaluations had been failures. After the unsuccessful attempt to spend their way out of economic stagnation in the aftermath of the oil crises of the 1970s, the centre-right government and later the Social Democratic government tried to use devaluation to address structural economic problems.

While the earlier devaluations had sought to regain lost competitiveness, the so-called 'superdevaluation' on October 8, 1982 was different in that it was an aggressive devaluation meant to create competitive advantages.[89] The Social Democrats had ironed out an economic strategy that involved a major devaluation, measures to improve price stability, restrictive fiscal policy, and reaching consensus between the trade unions and employer organizations to revive the Swedish economy.[90] The 'superdevaluation' was supposed to be the last devaluation and set Sweden on a hard currency trajectory.[91] However, the devaluation only temporarily masked the structural problems in the Swedish economy under windfall profits for Swedish export companies.[92]

The devaluation of 1982 had failed to improve the basis for economic growth, employment and income development, and as a consequence, Swedish

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[88] Broz and Frieden, "The Political Economy of International Monetary Relations,": 319.

[89] Lars Jonung, "Rivstart eller snedtändning? [Flying Start or Misfiring?]," in *Devalveringen 1982 - rivstart eller snedtändning? Perspektiv på svensk devalveringspolitik [The 1982 Devaluation: Flying Start or Misfiring? Perspectives on Swedish Devaluation Policy]* (Stockholm: SNS Förlag, 1991), 12-3.

[90] Hans Bergström, "Devalveringens politiska tillkomst och logik [The Political Creation and Logic of the Devaluation]," in *Devalveringen 1982 - rivstart eller snedtändning? Perspektiv på svensk devalveringspolitik [The 1982 Devaluation: Flying Start or Misfire? Perspectives on Swedish Devaluation Policy]*, ed. Lars Jonung (Stockholm: SNS Förlag, 1991), 288; Feldt, *Alla dessa dagar...: I regeringen 1982-1990 [All These Days...: In the Government 1982-1990]*, 67.

[91] Bergström, "Devalveringens politiska tillkomst och logik," 297.

[92] Magnus Henrekson, "Devalveringarnas effekter på den svenska ekonomins struktur [The Effect of the Devaluations on the Structure of the Swedish Economy]," in *Devalveringen 1982 - rivstart eller snedtändning? Perspektiv på svensk devalveringspolitik [The 1982 Devaluation: Flying Start or Misfire? Perspectives on Swedish Devaluation Policy]*, ed. Lars Jonung (Stockholm: SNS Förlag, 1991), 77.

political and economic elites, including most of the labour unions and employer organizations, firmly committed to a fixed exchange rate regime.[93] The history of devaluations had taught the political elite that a proactive devaluation might ruin crisis consciousness. While a proactive devaluation during the development of the financial crisis could have brought down the interest rates and halted the recession, the government feared that the labour market demands and calls for public sector expansion would increase to the extent that the momentum for austerity measures and structural reform would dissipate.[94]

Inspired by the public choice school's utility maximizing policymakers and voters[95], there was an idea that the establishment of norms and external pressures could steer the actors to maximize long term utility for the economy rather than their own short term benefits. The devaluations seemed to have proven the theory right and formed a consensus in the political and economic elites. In convincing the political elites of the importance of setting up firm long-term norms wherefrom economic actors could make rational decisions without fearing sudden interference of politicians, the annual reports from the economists at the Centre for Business and Policy Studies (SNS) played an important role.[96] However, SNS also commissioned the so-called 'Brookings report' from the American institute, where the authors came to the conclusion that a floating exchange rate regime might be the best solution to fight inflation.[97]

From the mid-1980s when they deregulated capital markets and declared that they would not borrow in foreign exchange, the Social Democrats had taken important steps in the direction of rejecting the previous Keynesian accommodation policies and embracing the monetarist norms based economic

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[93] Dennis, *500%*, 347-8; Jonathon W. Moses, "Floating Fortunes: Scandinavian Full Employment in the Tumultuous 1970s-1980s," in *Globalization, Europeanization and the End of Scandinavian Social Democracy?*, ed. Robert Geyer, Christine Ingebritsen, and Jonathon W. Moses (Basingstoke: Macmillan Press, 2000), 75. Interview with Kjell-Olof Feldt, 2004-02-10.

[94] Ton Notermans, "Europeanization and the Crisis of the Scandinavian Social Democracy," in *Globalization, Europeanization and the End of Scandinavian Social Democracy?*, ed. Robert Geyer, Christine Ingebritsen, and Jonathon W. Moses (Basingstoke: Macmillan Press, 2000), 42.

[95] See, for example, Anthony Downs, *An Economic Theory of Democracy* (New York, NY: Harper & Row, 1957).

[96] See, for example, Blyth, "The Transformation of the Swedish Model,": 18; Hamilton and Rolander, *Att leda Sverige in i krisen*, 51-2; Jonung, "Den finansiella revolutionen," 36; Lindbeck, "The Swedish Experiment,": 1303; Ryner, "Nordic Welfare Capitalism," 43; Ryner, *Capitalist Restructuring*, 175-6. For a response to the criticism and an attempt to restore the credibility of the norm policy strategy, see Hans Tson Söderström, *Normer och ekonomisk politik: Konjunkturrådet, normpolitiken och 90-talskrisen [Norms and Economic Policy: The SNS Economi Policy Group, Norm Policy, and the 1990s crisis]* (Stockholm: SNS Förlag, 1996).

[97] Alice M. Rivlin and others, *Brookingsrapporten: Den svenska ekonomins framtidsutsikter [The Brookings Report: The Future Prospects of the Swedish Economy]* (Stockholm: SNS Förlag, 1987), 100-1.

policies.[98] However, the new macroeconomic strategy was manifest when Minister of Finance Allan Larsson in the budget proposal of 1991 made inflation, rather than employment, the main priority for the government.[99] This sent an important signal to both the financial markets and the labour market that the government would let unemployment increase rather than realign the exchange rate in order to fight inflation. The Social Democrats saw low inflation as a necessity to maintain high employment and had come to the conclusion that devaluations would not solve Sweden's economic problems.[100] However, economists at the LO (Swedish Trade Union Confederation) publicly criticized turning the krona into hard currency and pointed out the advantages of a floating exchange rate regime or a realignment of the currency, but the Social Democratic government effectively cut the debate short to avoid appearing internally fractioned and counter speculation on devaluation.[101] In order to further confirm and increase the credibility of the new direction of economic policy, the board of governors of the Riksbank fixed the krona to the ECU in May 1991.[102] According to Villy Bergström, the new fixed exchange rate was slightly stronger than the target rate to the previous currency basket and this signalled that the government was serious in holding the fixed currency and fighting inflation.[103]

When it took power in the fall of 1991, the centre-right government decided to continue with the previous Social Democratic government's policies that prioritized low inflation before employment, and a firm commitment to the fixed currency.[104] While the Social Democratic government had formulated and introduced the policy of non-accommodation, the centre-right government followed through on this policy.[105] For the new Prime Minister, Carl Bildt, it was the experiences from previous decades that made both government and parliament support of the defence of the currency.[106] As Swedish parties and economists had agreed on the value of a fixed currency, the exchange rate regime was no longer an issue. The consent came to stifle the domestic debate on exchange

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[98] Ryner, "Nordic Welfare Capitalism," 37. See also Ryner, "Neoliberal Globalization,": 65-68; Ryner, *Capitalist Restructuring*, ch. 7.
[99] Ton Notermans, "The Abdication from National Policy Autonomy: Why the Macroeconomic Policy Regime Has Become So Unfavorable to Labor," *Politics & Society* 21, no. 2 (1993): 140.
[100] Interview with Ingvar Carlsson, 2004-02-11.
[101] Kask, *Vägen in i och ut ur krisen*, 165-8.
[102] Lindbeck, "The Swedish Experiment,": 1303.
[103] Quoted in Kask, *Vägen in i och ut ur krisen*, 111.
[104] Notermans, "Europeanization and the Crisis of the Scandinavian Social Democracy," 31. Interviews with Kjell-Olof Feldt, 2004-02-10, and Ingvar Carlsson, 2004-02-11.
[105] Lindbeck and others, *Turning Sweden Around*, 35. However, according to Kjell-Olof Feldt, the Social Democratic government never actually implemented any economic policy confirming the shift in priorities from employment to low inflation. Rather, it was the support of the centre-right government on the crisis packages in the fall of 1992 that in action proved the shift in priorities. Interview with Kjell-Olof Feldt, 2004-02-10.
[106] Bildt, "Den stapplande vägen till reformer och till Europa," 51.

rate policy.[107] Neither was there any international pressure for a different exchange rate regime. As Bäckström points out, the prevailing sentiment among economists, central bankers and international institutions, such as the IMF, was that floating currency regimes were not suitable for small open economies, because sudden exchange rate changes could cause domestic shocks and therefore it was preferable to operate a fixed exchange rate regime.[108]

Overall, there was very little questioning of the decision to defend the currency and the criticism that was voiced was either ignored or dismissed. According to Olle Wästberg, under-secretary at the Ministry of Finance, the defence of the krona was so obviously the right thing to do that it was not really a decision at all. Recognizing that informal decisions also matter, he prefers to call it a 'non-decision', because it went without saying that the government should defend the currency.[109]

The media also backed the decision to defend of the currency, although there were some dissenting voices. According to Teorell, there is hardly an editorial, opinion-piece, or statement from either politicians or economists that question the reasoning behind the crisis packages, i.e. the fixed currency, before the first crisis package.[110] Among the larger newspapers, Arbetet, a social democratic daily newspaper, is alone in consistently questioning the fixed currency.[111] While the dissenting voices are very few, they are either ignored or met with indignation.

The consensus among politicians, economists and the media also brought the public on board. Many Swedes perceived the fight that the Riksbank and the political elite put up to defend the currency as a patriotic duty, courageous and heroic, while observers in Europe had a hard time understanding what was going on.[112] For example, when Norman Lamont, the British Chancellor of the Exchequer, in an interview with the BBC just after the pound began its float on September 16, 1992 got the question why the British would not battle like the Swedes raising interest rates to 500 percent, he replied: "We use common sense."[113] In Sweden, on the other hand, the issue of devaluation was framed as an act of cowardice and a floating regime as attempting to conceal that coward-

[107] Jonung, "Den finansiella revolutionen," 36.
[108] Urban Bäckström, "1990-talets väg till prisstabilitet [The Road to Price Stability in the 1990s]," in *På jakt efter ett nytt ankare: Från fast kronkurs till inflationsmål [In Pursuit of a New Anchor: From a Fixed Krona to an Inflation Target]*, ed. Lars Jonung (Stockholm: SNS Förlag, 2003), 290.
[109] Phone interview with Olle Wästberg, 2004-03-17.
[110] Teorell, "Demokrati eller fåtalsvälde?", 65.
[111] Dennis, *500%*, 186.
[112] Elmbrant, *Så föll den svenska modellen*, 310-1; Robert Taylor, "Survey of Sweden (1): Unity Beats Speculators," *Financial Times*, 10 November 1992.
[113] Quoted in Dennis, *500%*, 340; Elmbrant, *Så föll den svenska modellen*, 333; Lundgren and Söderström, "Kronförsvaret hösten 1992," 199.

ice.[114] Carl Bildt praised the consensus in Parliament and stated that "in the course of the last few weeks we have fended off recurring threats against the value of the krona. With force and resolution, the government, the opposition, and the Riksbank have defended the krona. This policy has virtually full support of the Swedish people."[115] To some extent, the defence of the krona got reduced to a question of national prestige rather than what would be the best policy for the country.

Although there were few who openly questioned the fixed currency premises of the governmental policy, there are some exceptions. Arguably the most important challenge happened in the Parliament, when the leader of the right-wing populist party Ny Demokrati (New Democracy), Ian Wachtmeister, brought up the option of letting the currency float. He argued that the financial market would appreciate that Sweden changed course in the new situation after the Finnish markka, British pounds, Italian lira, and Spanish peseta had begun their float.[116] The response from Anne Wibble, the Minister of Finance, is brief and dismissive: "It makes me extraordinarily happy that Ian Wachtmeister has no influence in most areas, including economic policy."[117]

The consensus and determination of the political elite proved to be very persuasive and made an impression internationally. For example, hardly a week before the Riksbank gave up the defence of the krona in November 1992, the Financial Times thought that most observers were convinced that Sweden had gone through too much to resort to manipulation of the exchange rate as a way out of its trouble.[118] The sought-after credibility for the fixed exchange rate seemed to have formed, but rested on a very unstable foundation. Many of the actors close to the policy process believed that the defence effort would work right up until the krona was forced to float.[119] The consensus and firm belief in fixed currency had become so entrenched that when Carl Bildt admitted defeat and that the krona would have to float for some time, he also maintained that "you cannot run an economic policy with a floating exchange rate. European

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[114] Carl Bildt, "Vi var mer blåögda än svartmålande [We Were More Naive Than Pessimistic]," *Dagens Nyheter*, 19 November 2002.
[115] Sveriges Riksdag [The Swedish Parliament], "Protokoll [Record of Proceedings] 1992/93:2, October 6," (http://www.riksdagen.se/debatt/protokoll/index.asp: 1992), Anf. 3. My translation.
[116] Sveriges Riksdag [The Swedish Parliament], "Protokoll [Record of Proceedings] 1992/93:6, October 14," (http://www.riksdagen.se/debatt/protokoll/index.asp, 1992), Anf. 7.
[117] Ibid., Anf. 15. My translation.
[118] Robert Taylor, "Survey of Sweden (5): A Long, Hard Slog Back to Recovery - The Economic Recession," *Financial Times*, 10 November 1992.
[119] Interview with Carl B. Hamilton, 2004-03-10, and phone interview with Olle Wästberg, 2004-03-17.

countries cannot be floating against each other. It won't work. I don't believe in this policy."[120]

Consequently, the negative experiences of previous devaluations had led to a firm consensus among the Swedish political and economic elite about the importance of long-term norms and a firmly fixed currency as the correct measures to improve Swedish economic performance. The earlier attempts of fine-tuning and micromanagement of the economy had been discarded as failures by both the Social Democrats and the centre-right government. There was a failure to see the different circumstances in the previous devaluations and the one during the financial crisis. As Stern and Sundelius point out, "the crisis response was heavily affected by ambitions to retain, or even entrapment within, an established policy line, despite countervailing pressures from the external environment."[121] Consensus and experience came to limit rather than expand the search for solutions to the crisis. The government and opposition had so firmly locked itself into a specific definition and solution to a problem that it had become incapable of seeing and analysing the alternatives. It is always difficult to convincingly show that an alternative policy would have resulted in a decisively different result, but the failure to seriously consider and plan for such a policy option is dangerous.

Moving towards Europe

After having closed the door for membership in the European Community since the early 1960s on the grounds of Swedish neutrality policy, the Social Democrats began moving Sweden in the direction of membership in the late 1980s. The dynamic development of European cooperation had made the price for voluntary isolation higher and with the end of the Cold War the argument for neutrality began to fade.[122] According to Ingvar Carlsson, the Social Democrats wanted to participate fully in international cooperation but remain non-aligned in security-related issues.[123] The application for membership in the EC was triggered by capital outflows in the fall of 1990 that threatened the fixed currency policy of the Social Democrats and signalled financial market distrust in Social Democratic economic policies. As part of a broader program aimed to strengthen the credibility of the fixed currency and economic policy, the Social Democrats included the ambition to join the EC.[124] In the summer of 1991, only

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120 Robert Taylor, "Sweden Admits Defeat in the Battle for the Krona: Sudden Central Bank Move Takes Premier by Surprise," *Financial Times*, 20 November 1992.

121 Stern and Sundelius, "Sweden's Twin Monetary Crises of 1992,": 39.

122 Carlsson, *Så tänkte jag*, 379. See also Paul 't Hart and Jakob Gustavsson, "Foreign Economic Crisis, Reformist Leadership, and Policy Change: Lessons from Australia and Sweden," *Administrative Theory & Praxis* 24, no. 1 (2002).

123 Interview with Ingvar Carlsson, 2004-02-11

124 Carlsson, *Så tänkte jag*, 408-12; Notermans, "Europeanization and the Crisis of the Scandinavian Social Democracy," 42. Interview with Ingvar Carlsson, 2004-02-11

months before exiting the government, the Social Democrats had tied the krona to the ECU and submitted the Swedish application for membership and thereby taken the initial steps on the road to entering the European Community.[125]

The incoming government had in its political platform made membership in the European Community its primary objective and connected this objective with the fixed currency policy and structural reforms of the economy.[126] The EC professed stable exchange rates and the ERM as important steps towards the creation of the inner market. Consequently, membership necessitated low inflation, fixed currency and reforms to remain competitive and the government modelled its program on meeting this objective.[127] As Anne Wibble retrospectively observed, "it would not have been a good start to the negotiations to just have devalued."[128]

In the statement of government policy when the parliamentary year opened on October 6, 1992, the Prime Minister again emphasised the connection between the hard currency policy and the participation in the European Community. Carl Bildt stated that Sweden's prosperity was dependent upon "participation in the economic and monetary cooperation in Europe and our hard currency policy."[129]

Although the economic recovery would take time and effort, the government and the Social Democrats agreed on the framework of what needed to be done. As the Financial Times pointed out in its survey of Sweden, "all sides hope to adapt Sweden to the rigours of the European Community after 1995. This means a rapid adjustment in laying down the foundations for future growth."[130] The correspondent also pointed out that the government would resist abandoning the defence of the currency because "such a U-turn would destroy Sweden's determination to be a model EC member in 1995."[131]

In the fall of 1992, the financial pressures were so hard on many European currencies that realignment became the norm rather than the exception. Instead of following the European norm, Sweden took the exceptional position of defending its currency and thus wanted to signal its worthiness of membership. However, when Italy, the UK and Spain realigned or floated their exchange

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[125] Carlsson, *Så tänkte jag*, 419.
[126] Bildt, "Den stapplande vägen till reformer och till Europa," 55; Carl Bildt and Bengt Westerberg, "Vi underskattade krisen [We Underestimated the Crisis]," *Dagens Nyheter*, 3 October 2001. Interview with Carl B. Hamilton, 2004-03-10.
[127] Phone interview with Olle Wästberg, 2004-03-17.
[128] Anne Wibble, "Ekonomerna och 90-talskrisen [The Economists and the Crisis of the 1990s]," in *Ekonomerna i debatten: Gör de någon nytta? [The Economists in the Debate: Are They Useful?]*, ed. Lars Jonung (Stockholm: Ekerlids Förlag, 1996), 211. My translation.
[129] Sveriges Riksdag [The Swedish Parliament], "Protokoll 1992/93:2," Anf. 3; Teorell, "Demokrati eller fåtalsvälde?", 66.
[130] Taylor, "Survey of Sweden (5): A Long, Hard Slog Back to Recovery - The Economic Recession,".
[131] Ibid.

rates in relation to the EMS/ERM, the Riksbank and the Ministry of Finance began questioning the ECU as the basis for a fixed exchange rate regime. The assessment was that a new exchange rate regime with the krona unilaterally fixed to the German Mark or associated within the EMS/ERM would increase the credibility of the fixed exchange rate policy and serve Sweden better than the unilateral tie to ECU.[132] Although the government and Riksbank made a strong effort to create a new association for the krona, the negative economic development in Sweden, the realization that fundamental imbalances would delay a recovery, and the growing internal problems within the EMS/ERM reduced European enthusiasm to accommodate the Swedish ambition to change the existing exchange rate regime. The forced float of the krona overtook the option of a new fixed exchange rate regime.[133]

The decision to defend the currency turned into a policy dilemma in the domestic and external relations of the government. The objectives in domestic and external relations clashed when high interest rates were needed to hold the exchange rate, but the high interest rates simultaneously pushed up costs for the banks and limited economic activity in Sweden. The more the Riksbank tried to defend the currency with the interest rate weapon, the worse the situation for the domestic economy.[134]

While the fixed currency was important to qualify for EC membership, so was economic performance and low interest rates. In this situation, the Swedish government failed to see that realignment was fundamentally different from previous devaluations. Whereas the 'super-devaluation' of 1982 had been implemented in order to increase export-sector competitiveness and domestic employment, the realignment in the fall of 1992 would have been a correction of a seriously overvalued exchange rate. When the currency finally had to float it depreciated with more than 20 percent.[135] Instead of following the examples of Finland and the United Kingdom – both important trading partners that decided to devalue rather than defend their currencies in September 1992 – Sweden used its foreign exchange reserves, combined with extensive international borrowing, to weather the attack. When the next severe attack on the currency came in November 1992, the same strategy was initially applied. This time, however, the outflows were so large that the combination of existing foreign exchange reserves and resumed intensive borrowing could not reverse the market forces. When the Riksbank and the Swedish National Debt Office could not take up new loans fast enough to replenish the currency reserves, the policy was changed and the krona was allowed to float.[136]

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[132] Dennis, *500%*, 274; Hamilton and Stuart, "I stormens öga," 123-4.
[133] Dennis, *500%*, 282; Hamilton and Stuart, "I stormens öga," 159-60.
[134] Jonung, "Den finansiella revolutionen," 34.
[135] Lundgren and Söderström, "Kronförsvaret hösten 1992," 183.
[136] Phone interview with Åke Lönnberg, 2004-06-09.

In hindsight, for example, Bengt Westerberg thinks that if the government had analysed the situation correctly, it should have been able to realize that devaluation was necessary, and Ingvar Carlsson thinks that Sweden should have stopped the defence of its currency when Finland and the UK stopped defending theirs, thereby averting what became a humiliating defeat for Swedish democracy.[137] In the end the consensus on rejecting devaluation and urge to qualify for the EC led to the prioritization to defend the currency before other policy options. As the Lex Column in the Financial Times put it after the floating of the krona: "Sweden's decision to float its currency has again highlighted the absurdity of running a tight money policy in the face of recession."[138]

Underestimating the severity of the financial crisis

The government was aware of the economic problems in the Swedish economy, but underestimated the depth, scope, and severity of the financial crisis. According to Bengt Westerberg, deputy prime minister, the perspective of the government was that Sweden suffered from a normal downturn in economic activity and that there was no need to prepare a worst-case scenario or plan alternative policy options.[139] An important reason that both the centre-right and Social Democratic government underestimated the severity of the situation and drew so much on the experiences of the previous devaluations was that they had not understood what happens in the aftermath of financial deregulation. According to Jonung, the models used to forecast economic development at the Riksbank, the Ministry of Finance and the National Institute of Economic Research (Konjunkturinstitutet) had failed to incorporate the variables that created the financial crisis and instead continued to operate on the presumptions made when the financial market still was regulated. As the crisis deepened, the forecast mistakes increased.[140] The models serve as base for governmental policy considerations and in being inaccurate led the government false conclusions about the problem and its solution. While models only can provide approximations of reality, the failure to adapt the models to the changes in the environment exacerbated the mismatch between cause and effect of policy measures and heightened the chances of applying inefficient or even counterproductive policies.

In believing the situation was under control and the analysis correct, there was only limited planning for alternative policy options.[141] Apart from three memoranda, two in the Ministry of Finance and one in the Prime Minister's Office, the alternatives to holding the fixed currency were never up for serious

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[137] Interviews with Ingvar Carlsson, 2004-02-11, and Bengt Westerberg 2004-02-26.
[138] "The Lex Column: That Strain Again," *Financial Times*, 21 November 1992.
[139] Interview with Bengt Westerberg, 2004-02-26.
[140] Jonung, "Den finansiella revolutionen," 38.
[141] Phone interview with Olle Wästberg, 2004-03-17.

discussion within the government.[142] However, Carl B. Hamilton, political advisor to the Minister of Finance, points out that the government's perspective was that devaluation would not solve the problems in the Swedish economy, but rather extinguish the credibility of the economic policy. This credibility was necessary to successfully reform the Swedish economy.[143]

At the same time, the fear of alerting or worrying the financial market forced any probing discussion underground and away from public attention. For example, the Prime Minister's economic advisor Lars Jonung was a constant worry to the Riksbank and Ministry of Finance and he had firm restrictions on voicing his opinions to the media.[144] The potential cost of cracks in the united and determined façade was an obstacle to serious consideration of the alternatives.

The situation was similar at the Riksbank. According to Krister Andersson, Chief Economist at the Riksbank, they internally discussed alternative exchange rate regimes but were convinced that devaluation would be costly in terms of having lost established market credibility and once again having to bring down inflationary expectations. Instead, their analysis focused on what economic policy was needed to maintain the fixed currency regime.[145]

In failing to factor in the implications of both the rise of global finance and the deregulation of the Swedish financial market, Sweden's political and economic elites continued their dogmatic pursuit of the fixed currency policy without adjusting policy in accordance with the warning signals from the market. Rather than recognizing that a new situation had emerged and broadly searching for a solution as did the banking crisis, the government held on to its fixed currency norm until the global financial markets forced the krona to float. According to Bengt Westerberg, globalization had not yet entered the vocabulary, although internationalization and international dependence were up for discussion regularly.[146] While the discussion was usually related to trade or access to resources, the political consequences of capital mobility and rapidly globalizing financial markets was rarely an issue. The reasoning behind the fixed currency commitment in the Liberal Party (Folkpartiet) was that it was necessary for the international performance and credibility of the Swedish economy.[147] Ingvar Carlsson concedes that there was "an idyllic perception of the financial markets and the forces in operation on these markets" and he believed that political unity and mobilization would be enough to counter the attacks on the krona.[148] Anne Wibble expressed the same opinion during the crisis: "There is a national

[142] Hamilton and Stuart, "I stormens öga," 117-20.
[143] Interview with Carl B. Hamilton, 2004-03-10.
[144] Dennis, *500%;* Hamilton and Stuart, "I stormens öga," 139-40.
[145] Andersson, "Utformningen av inflationsmålet," 227.
[146] Interview with Bengt Westerberg, 2004-02-26.
[147] Ibid.
[148] Interview with Ingvar Carlsson, 2004-02-11.

consensus and that ought to convince the international market."[149] Carl Bildt, on the other hand, gives the impression to have missed the volatile nature of the financial market. In the Financial Times, he complains that "what I cannot understand is why the market should react now to our political situation when it did not do so before,"[150] He also claims that "markets are wrong" and thinks that the market should appreciate the bold free market strategy of the government.[151]

Distribution of costs for realignment

From an IPE point of view, it would seem reasonable that distributional concerns played a role in the government's decision to defend the currency. This was also a major issue in the Swedish debate after the financial crisis. However, there is very limited and at most circumstantial evidence pointing in one direction or another. In retrospect it is clear that the extended defence had distributional consequences, especially on those individuals and companies with little or no liquidity to carry them over the extreme interest rate peaks. However, in comparison with the more general effects of the financial crisis, such as falling asset prices primarily on real-estate, the high real interest rates, the recession and increasing unemployment, and restructuring of public finances in the aftermath, it seems that the defence and devaluation had a relatively limited effect.

The initial rationale for defending the currency at the Riksbank was to buy time for the policymakers to deal with the imbalances in the economy. The Riksbank either hiked interest rates or intervened on the foreign exchange market to create this respite.[152] However, once the government had set out on the path to defend the currency there might be some evidence that the distributional consequences of the devaluation mattered for the continuation of the defence effort. According to Jonung, there were strong moral and distributional reasons to defend the fixed exchange rate, because politicians had promised to defend the currency and as a consequence invited municipalities, companies and individuals to take up loans abroad.[153] Anne Wibble makes a similar argument when she states that the government had an obligation to show small businesses and others who had trusted fixed currency policy of consecutive

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[149] Taylor and Webb, "Swedish Money Rate Hits 75%,".
[150] Robert Taylor, "Small Boat on Stormy Sea: Sweden's Economic Malaise," *Financial Times*, 4 September 1992.
[151] Taylor, "Sweden Gripped by a Crisis of Confidence,".
[152] Dennis, *500%*, 152. After the failure of the defence of the currency, the argument has been made that it was an investment in the future credibility of Swedish economic policy. This has been difficult to prove empirically. See, for example, Lars Jonung, Hans Tson Söderström, and Joakim Stymne, "Depression in the North - Boom and Bust in Sweden and Finland, 1985-93," *Finnish Economic Papers* 9, no. 1 (1996): 68; Lundgren and Söderström, "Kronförsvaret hösten 1992," 209-12.
[153] Jonung, "Den finansiella revolutionen," 49.

governments that they had not been fooled intentionally and therefore the government had to defend the currency.[154] Allan Larsson, Minister of Finance in the Social Democratic government, agrees with Anne Wibble that in running a balance of payment deficit while holding on to the norm established in 1984 to refrain from taking loans in foreign currency (valutalånenormen), the governments had effectively forced businesses and others to take up loans in foreign currency and take on the devaluation risk on their behalf.[155] However, Dennis argues that everyone, especially after Italy and Britain gave up their currency defences, had the opportunity to consider the risks they were willing to take on and time to exit their currency positions.[156]

There has been criticism of the government and Riksbank on the basis that they in extending the defence for so long effectively nationalized and accommodated the foreign exchange losses for companies and speculators. In defending the currency, companies got some respite to exit loans in foreign currency and in this sense the devaluation risk was accommodated by society.[157] Although any estimate of cost of the defence is mired in complexity and per definition imprecise, Dennis comes to the conclusion that the net cost of the defence for the Riksbank and the National Debt Office to 14 billion krona and the net gain from the devaluation in the private sector (including municipalities and excluding banks) to 7 billion krona.[158] This would at least indicate that some of the devaluation risk was nationalized.

Although the defence effort gave ample opportunity for speculation and redistributed capital between the actors, there is little evidence for the conspiratorial claims that the government and Riksbank defended the currency so fervently to help specific companies exit their currency positions.[159] However, even if the evidence is circumstantial and the government may, intentionally or not, have shouldered some of burden of the corporate sector in prolonging the defence effort. The argument for nationalizing the foreign exchange losses in the companies was that the public would suffer one way or the other. Either the public would lose their jobs from companies going out of business and laying off workers, or they would have to bear the costs for the state as taxpayers repaying the national debt and getting less welfare services for their money. The question then became how to minimize the long-term cost and maximize the long-term viability of the Swedish businesses and economy. In this vein and against the ideological grain of the government, the LO argued that the state

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[154] Ewa Stenberg and Gunnar Örn, "De spelade bort sexton miljarder [They Gambled Away Sixteen Billion]," *Dagens Nyheter*, 3 November 1996.
[155] Ibid.
[156] Dennis, *500%*, 308-9.
[157] Hamilton and Rolander, *Att leda Sverige in i krisen*, 71.
[158] Dennis, *500%*, 305, 307.
[159] See, for example, Ulla Reinius, *Stålbadet: Finanskrisen, Penserkraschen och Nordbankens rekonstruktion* (Stockholm: Ekerlids Förlag, 1996).

should take over a large part of the currency risks for companies by taking up loans internationally of the equivalent of 300-400 billion krona and use it to buy back Swedish bonds.[160]

For the many multinational companies based in Sweden, such as Volvo, Electrolux, Stora and Astra, the high interest rates in defence of the currency did not seem to matter. For example, Claes Dahlbäck, CEO of the Wallenberg sphere's investment company Investor, meant that "the short-term interest rate rises have no impact at all on us" and that the company fully supported the action of the Central Bank.[161] In the end many of the large Swedish companies made substantial exchange rate losses (SAS lost over a billion krona and Trelleborg estimated its loss to more than 700 million krona) whereas others gained (Astra gained 470 million krona).[162] There is no clear-cut evidence that certain groups were winners and others losers on the extended currency defence, while specific companies and some individuals made both handsome profits and severe losses.

In the end, it was not only companies and individuals that exited currency positions or hedged against currency risks. LO, for example, covered a loan by forward contract on November 19, 1992, just before the Riksbank had to let to krona float. In saving 40 million krona, there were insider accusations and a debate regarding whether Stig Malm, LO chairman and member of the executive committee of the Social Democratic Party, knew and acted upon the fact that the Social Democrats would reject a third crisis package.[163]

The government with the backing of the Social Democrats came to the decision to defend the currency and pursued this policy despite warning signals until it was forced to let the krona float. Although there were options available, the policy rigidity stemmed from previous negative experiences with devaluation, elite consensus on the problem and its solution, the political objective to move towards European cooperation, and policymakers underestimating the severity and scope of the financial crisis. The distribution of cost for the defending the currency may marginally have extended the defence effort.

7.5. Policy choice in the decision to build a political coalition

As argued above, the government had a number of options in its decision to build a political coalition. The building of a political coalition was a conse-

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[160]Dennis, *500%*, 171-2, 177, 309; Per-Olof Edin, "Så undviker vi devalvering [This Is How We Avoid Devaluation]," *Dagens Nyheter*, 29 September 1992.

[161] Robert Taylor and Sara Webb, "Warning over Economy," *Financial Times*, 11 September 1992.

[162] Dennis, *500%*.

[163] Tomas Lisinski, "LO säkrade lån innan kronan började flyta [LO Secured Loans before the Krona Began to Float]," *Dagens Nyheter*, 6 May 1993.

quence of the decisions to defend the currency and support the banks. To that extent, it was a measure to augment and sustain the crisis management effort as the financial crisis had become acute and the initial effect of the interest rate hikes and money market interventions of the Riksbank was wearing off. This section analyses why and how the government and Social Democratic opposition managed to build a political coalition. There are two factors that are particularly important in the government's choice to cooperate and closing two crisis packages with the Social Democrats. They are the crisis situation and outside brokers and will be analysed separately below.

The crisis situation

The acute crisis situation was a prerequisite for the government and opposition to come together in something resembling the most recent Swedish coalition government during World War II. When the capital outflows continued despite interventions and interest rates hikes from the Riksbank, the government either had to let the krona float or attempt to bolster the credibility of the exchange rate with policy measures.[164] Thus, the unfolding situation put policymakers in a position where they had to come to a decision about how to manage the crisis, and they preferred the building of a political coalition to letting the krona devalue. As the financial crisis worsened and the rationale for a coalition increased, it also became easier to overcome ideological and personal differences among the political elite. For example, the personal antipathy between Ingvar Carlsson and Carl Bildt was fierce enough to make the Financial Times doubt the possibilities of a political coalition backing a crisis package.[165] However, the rapidly deteriorating crisis situation was perceived as critical enough to postpone normal political conflict and bring the adversaries together to negotiate and agree to cooperate on two crisis packages. As Bengt Westerberg puts it, "The acuteness of the crisis released political creativity to address the situation."[166]

In the run-up to the first crisis package launched on September 20, 1992, the government and the Riksbank realized that the interest rate hikes only were temporary measures that would lead to increasingly detrimental consequences for the domestic economy the longer they were in place. However, Minister of Finance Anne Wibble still thought that the cost of abandoning the krona would be higher and thus saw the defence of the currency as a necessity.[167] Wibble was set on continuing the defence of the currency and pointed out in her personal

[164] Dennis, *500%*, 54.
[165] Taylor, "Sweden Gripped by a Crisis of Confidence,".
[166] Interview with Bengt Westerberg, 2004-02-26.
[167] Dennis, *500%*, 55.

notes that "the market has a long memory, it never forgets the countries that try to devalue their way out of trouble."[168]

In this situation, hiking the interest rate became a measure to buy time to solve the financial crisis without having to change the exchange rate regime. Dennis states in his memoirs that the purpose of the 500 percent interest rate was to make it clear to everyone that the exchange rate was to remain fixed and give the policymakers respite to consider and decide on fiscal policy measures.[169] Although unsustainable of a longer period, this interest rate made it extremely expensive to for financial market actors to go short in krona and effectively stopped the speculative outflows.[170] Since the government chose to defend the currency despite the pressure on the currency, the need for a political coalition increased. The government had to gain credibility both for the currency and the measures to correct the imbalances in the Swedish economy. In this respect, the political coalition was a necessary response to augment and sustain the crisis management effort.

The Swedish political and economic elite, including the government, the Social Democratic opposition, trade unions and business organizations had committed to the fixed currency. This obviously made it harder to float the krona, but at the same time facilitated the search for coalition partners. Although the Riksbank increased the interest rate to 75 percent on September 9, 1992, Anne Wibble tried to talk down the pressure on the currency and pointed out that, "there is a national consensus and that ought to convince the international markets."[171] The high interest rates became the tool to win the time to put together a crisis package aimed to strengthen the credibility for the krona, while the national political consensus on the fixed currency policy facilitated the assembly of a political coalition to counteract the speculation on the krona.

The general ambition with the political coalition was to defend the currency against speculation, solve the acute economic crisis, and stabilize the situation in the long-term.[172] The primary target of the first crisis package was the budget deficit, but the general support of the banks was also discussed. Although the problems in the banking sector were discussed and support for the banks was agreed upon in the negotiations, this issue was kept separate from the first crisis package. However, only a few days later on September 24 the situation in the banking sector had deteriorated to the point where the govern-

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[168] Quoted in Hamilton and Stuart, "I stormens öga," 143. My translation.
[169] Dennis, *500%*, 70.
[170] Lars Hörngren and Hans Lindberg, "The Struggle to Turn the Swedish Krona into a Hard Currency," in *Exchange Rate Policies in the Nordic Countries*, ed. Johnny Åkerholm and Alberto Giovannini (London: Centre for Economic Policy Research, 1994), 153.
[171] Taylor and Webb, "Swedish Money Rate Hits 75%,".
[172] Carlsson, *Så tänkte jag*, 486.

ment and Social Democrats had to launch the general support of the banking sector.[173]

The cooperation between the government and the Social Democrats went very well on this issue. For example, it was a joint effort between the government and the Social Democrats to write the proposition text to codify the negotiated agreement on the banking guarantee.[174] According to Stefan Ingves, no political debate could be allowed in this effort because a misperceived statement could have shattered the credibility of the measures. In his view, the political unity behind the banking guarantee played a decisive role in saving the Swedish banking system, and once the crisis packages were launched and the bank support measures had gone through Parliament in a close to unanimous vote, it became easier to convince financial market actors of the sustainability and seriousness of the measures.[175]

During the fall of 1992 most of the political and economic elite had not only committed to the fixed currency, but also believed that the credibility of the currency only could be maintained with a fast reduction in the budget deficit. However, as Calmfors argues, the elites failed to appreciate that market expectations on devaluation also could emanate from the fast increases in unemployment which in turn created political pressures to adjust the exchange rate.[176] When the first crisis package proved insufficient, the coalition had to take further measures. The second crisis package presented on September 30, 1992 addressed the cost level in Sweden by withdrawing two vacation days and lowering employer fees, a so-called internal devaluation, to make Swedish industry more competitive. In effect, this was the first political admission that the cost level was a problem.[177] The two crisis packages temporarily restored the confidence in the currency and the Social Democratic party secretary, Mona Sahlin, proclaimed that "politics have won over the market."[178] Carl Bildt, on the other hand, argued that those who had speculated on the devaluation of the krona would be the ones to lose. "They can feel ripped-off, substantially ripped-off," he observed.[179] During the crisis negotiations, Ingvar Carlsson firmly believed that Sweden's broad political unity would be sufficient to counter the pressures on the currency, but admits in retrospect that there was quite an idyllic perception of the forces in play on the financial markets.[180]

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[173] Ibid., 493; Lundgren, *När bubblan brast*, 157-9.

[174] Phone interview with Stefan Ingves, 2004-02-26. Lundgren, *När bubblan brast*, 181.

[175] Phone interview with Stefan Ingves, 2004-02-26.

[176] Calmfors, "Nationalekonomernas roll under det senaste decenniet: Vilka är lärdomarna? [The Role of the Economists during the Last Decade: What Are the Lessons?]," 237.

[177] Wibble, *Två cigg och en kopp kaffe*, 33.

[178] Quote from Marianne Björklund, Anders Olsson, and Dan Olsson, "94 dagar som skakade Sverige [94 Days that Shook Sweden]," *Dagens Nyheter*, 13 September 2002.

[179] Thorbjörn Spängs, "Krispaket fick ner räntorna: Glädjeyra på börsen [Crisis Package Lowered Interest Rates: Hausse on the Stock Exchange]," *Dagens Nyheter*, 1 October 1992.

[180] Interview with Ingvar Carlsson, 2004-02-11.

Although the minority government was keen to form a political coalition to strengthen its crisis management effort, it obviously could not form one without the agreement of some other party. According to Ingvar Carlsson, the Social Democrats had signalled their willingness to cooperate with the government on August 23, 1992 five weeks before the final negotiations started.[181] The opened door got little attention in the newspapers[182] because the media had their focus on the governmental meeting at Harpsund and had very low expectations of cooperation between the government and the Social Democratic opposition.[183] Simultaneously, Anne Wibble and Bengt Westerberg had proposed that Carl Bildt should contact Ingvar Carlsson to probe the willingness of the Social Democrats to back measures to strengthen the budget.[184] This would reveal both whether the Social Democrats were serious or not and make it harder for them to back out of supporting measures.[185] Consequently, the government and the Social Democratic opposition independently came to the same conclusion that the country might need political cooperation and unity to fend off speculation and hold the fixed currency.

On August 26, after the Riksbank had increased the interest rate to 16 percent, Carl Bildt reluctantly contacted Ingvar Carlsson and established a secret channel for cooperation.[186] Although the contacts were made and a working group met regularly (Carl B. Hamilton and Olle Wästberg from the government and Jan O. Karlsson and Leif Pagrotsky from the Social Democrats), it took time to produce an agreement. Therefore, on September 16, Anne Wibble was still willing to test the response to a crisis package on both the Social Democrats and Ny Demokrati.[187] It was not until the morning of September 17, when the crisis had reached an acute stage that the discussions between the government and opposition became public, when Bildt and Carlsson issued a joint press release.[188] According to Wibble, the press release committed both parts to reach an agreement and late on Friday, September 18, constructive negotiations commenced. (At this point, however, Bildt still wanted to keep a channel of communication open with Ny Demokrati in case negotiations with SAP failed.[189]) Early on Saturday morning the government and the Social Democrats were able to produce an agreement to strengthen public finances by about 20 billion krona.[190] The record shows that the option of building a political coalition with Ny De-

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[181] Carlsson, *Så tänkte jag*, 489.
[182] Ibid., 474-5.
[183] Elmbrant, *Så föll den svenska modellen*, 298.
[184] Wibble, *Två cigg och en kopp kaffe*, 25-6.
[185] Interview with Bengt Westerberg 2004-02-26. See also Bildt, "Den stapplande vägen till reformer och till Europa," 63.
[186] Elmbrant, *Så föll den svenska modellen*, 300; Wibble, *Två cigg och en kopp kaffe*, 26.
[187] Hamilton and Stuart, "I stormens öga," 129.
[188] Carlsson, *Så tänkte jag*, 486; Dennis, *500%*, 57; Elmbrant, *Så föll den svenska modellen*, 302.
[189] Teorell, "Demokrati eller fåtalsvälde?", 56.
[190] Dennis, *500%*, 71.

mokrati, rather than the Social Democrats, was held open as long as possible, but that the government preferred to build a coalition with the Social Democrats.[191] An agreement with the Social Democrats would not only mean that the crisis package had wider support in Parliament, but also convey stronger resolution in reaching a commitment across the traditional political division.

The decision of the SAP to support the government was of course a gamble on a future pay-off. On the one hand, it could help them win the next election, or on the other hand it could further alienate and frustrate the electorate that had already forced them out of office in the previous election. As the Financial Times pointed out after the first crisis package, "now the party can claim to have played a vital part in saving the economy from collapse although at the price of sacrificing many of its welfare saving plans."[192] However, cooperation would let the party influence the direction of the crisis packages and government policies, while the reforms still could be blamed on the financial crisis and the sitting government. Cooperation could also reaffirm and strengthen the image of the Social Democrats as a party taking care of the country even when they were out of office and pave the way for a return to government.[193] A decision not to cooperate, on the other hand, could portray the party as irresponsible and also worsen the condition of the Swedish economy and force the SAP to dismantle parts of the welfare state on its own upon returning to government. The party leadership felt that they had more to win than lose in supporting the government. According to Ingvar Carlsson, he and Allan Larsson saw it as the duty of the Social Democrats to support the government because of the seriousness of the situation and the belief that a coalition would have better chances to succeed in repelling attacks on the currency. There was also the hope that acting responsibly would open up opportunities to cooperate with one or more parties out of the centre-right government once the Social Democrats were back in power.[194] In that respect, the SAP support of the crisis packages could be seen as something of an investment in the future.

Despite the severe crisis situation and the growing awareness of the stakes involved, it was not without complication for the centre-right government and the Social Democrats to come to an agreement. While both sides had to come up with sufficient measures to win credibility in the market, they also had to be able to justify and retroactively legitimize the measures in their respective party organizations.[195]

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[191] Teorell, "Demokrati eller fåtalsvälde?", 56.

[192] Robert Taylor, "Sweden Unveils Rescue Package: All Parties Back Plans to Save Skr 28bn through Benefit Cuts and Tax Rises," *Financial Times*, 21 September 1992.

[193] Björklund, Olsson, and Olsson, "94 dagar som skakade Sverige [94 Days that Shook Sweden],".

[194] Interview with Ingvar Carlsson, 2004-02-11.

[195] For a detailed study of the communication between party leadership and party organizations during the financial crisis, see Teorell, "Demokrati eller fåtalsvälde?", ch. 3-4.

There was also mutual distrust between the delegations representing the government and the Social Democrats. In actually bridging this divide during the negotiations and finally reaching an agreement, many of the participants have mentioned the importance of Bengt Westerberg, the deputy prime minister and party leader for the Liberal Party.[196] He worked on both a personal level easing the tension between Ingvar Carlsson and Carl Bildt and on a political level defusing the animosity and mistrust between the two delegations. For Westerberg himself there was also a personal stake in accomplishing a coalition between the Social Democrats and the government, rather than seeking out the approval of Ny Demokrati, which he had deeply despised since the last general election. As Ingvar Carlsson points out in an interview, "the alternative would have been to make a deal with Ny Demokrati and Westerberg refused to do that."[197]

In finally agreeing on the first crisis package, the government and Social Democrats wanted to signal to the financial market that it was in charge of the situation and able to take responsible measures to turn the economic situation around. Political sacrifice would create credibility for the measures and the crisis packages show that policymakers can make tough choices and shoulder the responsibility.[198] The hope was that this would defuse the worries emanating from the fact that Sweden was led by a minority government and increase the credibility for the measures. According to Bengt Westerberg, in negotiating the crisis packages "the symbolism was as important as the substance."[199] However, the political consensus backing the crisis package was not firm enough. When the Moderates and Social Democrats soon after the presentation of the first crisis package disagreed on its actual content the credibility of the coalition diminished.[200] The Financial Times commented that "doubts and confusion emerged over the exact details of the all-party budget cuts package announced in outline on Sunday evening."[201]

The disagreement was serious enough for the Moderates in the government to demand and establish renewed contacts with Ny Demokrati.[202] The disagreement stemmed from what had actually been agreed upon in the negotiation of the crisis package. In order to maximize the effect of the crisis package, many of the measures would not be implemented immediately but rather at

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196 See, for example, Carlsson, *Så tänkte jag*, 492; Mona Sahlin, *Med mina ord [With My Words]* (Stockholm: Rabén Prisma, 1996), 142; Wibble, *Två cigg och en kopp kaffe*, 29-30.
197 Björklund, Olsson, and Olsson, "94 dagar som skakade Sverige [94 Days that Shook Sweden],". My translation.
198 Interview with Bengt Westerberg, 2004-02-26.
199 Ibid.
200 Elmbrant, *Så föll den svenska modellen*, 308.
201 Robert Taylor, "Maastricht - After the French Vote: Sweden Tries to Calm Markets," *Financial Times*, 22 September 1992.
202 Wästberg, *Det tomma rummet: Om politikens vanmakt [The Empty Room: On the Powerlessness of Politics]*, 134.

some date in the future. By presenting future reforms, rather than immediately implementing measures, the coalition hoped both to signal its ambition to the financial markets and to impress them with the scope of the agreement. According to Carl B. Hamilton, the inclusion and presentation of future reforms was a smart move, but also a problem because it led to disagreement after the negotiations about what had been accomplished, which undermined the credibility of the crisis package. He also thinks it is very problematic to come to such decisive agreements based on high-pressure, late-night negotiations. The lack of time, analysis and preparations increases the possibility for mistakes to be made and unintended consequences to occur. Overall, the situation illustrates the necessity of building political support to implement successful changes in the welfare system.[203]

When the government finally settled on building a political coalition with the Social Democrats, there were serious time constraints on producing an agreement.[204] The globalization of financial market had considerably reduced the time available for domestic adjustment and reform to bring down the market pressure on the overvalued exchange rate.[205] As a consequence of the intersubjective nature of the global financial market, the government needed to rapidly relay its intentions in order to convince the financial markets that credible and effective policy measures were underway. Hence, the political coalition became a signalling device between the policymakers and the financial markets. Although valuable time was lost in settling on a coalition partner and producing a crisis package, the deteriorating crisis situation prodded the coalition partners to reach a compromise at all.

In convincing the financial markets that the reforms were effective and credible, and that Sweden's political unity was strong enough to implement the measures, the coalition hoped to lower the risk premium needed for holding assets denominated in Swedish currency and bring down the interest rate. In the signalling effort, interviews in the international press were important. According to Olle Wästberg, under-secretary in the Ministry of Finance, the Financial Times had particularly good access to the policymakers. There was also a steady stream of press conferences in which both Bildt and Wibble participated. While the crisis packages were important signals to the markets, the capital flows worked as the markets' response and warning signal.[206]

The crisis packages and political unity were also important signals to the domestic sphere. They built the awareness of the crisis and the realization that measures and sacrifices were necessary to take the country out of the situation. Opinion polls showed that the public was enthusiastic about both the crisis

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[203] Interview with Carl B. Hamilton, 2004-03-10.
[204] Bildt, "Den stapplande vägen till reformer och till Europa," 66.
[205] Lindbeck, "The Swedish Experiment,": 1307.
[206] Phone interview with Olle Wästberg, 2004-03-17.

packages.[207] In a poll carried out by SIFO after the first crisis package, 78 percent were in favour and only 11 percent thought it was bad for Sweden and after the second crisis package 82 percent supported the effort.[208] Although alarming and costly for many individuals, the crisis situation rallied the Swedish people behind the political coalition and this further improved the impression on the financial market. Incrementally, the Riksbank could lower the marginal interest rate that bottomed at 11.5 percent on November 10, 1992.[209] However, new market pressures pushed up the interest rate again on November 19, 1992, and later that day the Riksbank let to krona float, when the political system failed to produce a third crisis package.

Facilitators

Apart from the deepening financial crisis pushing the government to build a political coalition with the Social Democrats, there was some important outside brokerage that facilitated a common political interpretation of the crisis situation, what needed to be done, and how to present it to defend the fixed currency regime. Domestically, the Riksbank had the rather vaguely formulated but legal mandate to consult the government on important issues regarding monetary policy decision.[210] Drawing on this mandate, the governor of the Riksbank, Bengt Dennis, came to play an important personal role in pushing the political elite to produce the crisis packages. Externally, the IMF's article IV delegation provided pressure on the political parties to take responsible measures to stabilize the Swedish economy. The coordination between the Riksbank and the IMF delegation came to further increase the pressure on the political system to produce a coalition.

The Riksbank held the short-term instruments to hold the fixed currency. In hiking the interest rate or intervening in the market, the Riksbank could counterbalance capital flows so that the currency remained fixed to the ECU. The board of governors had vested emergency powers in its governor in November 1990.[211] As the capital flows increased and Bengt Dennis autonomously hiked the overnight marginal interest rate to 500 percent, he effectively presented the political system with a *fait accompli*; either the Riksbank has to let go of the fixed exchange rate regime or you have to produce a crisis package that convinces the financial markets of the viability of the fixed currency. After all, interest rates at such a level can only be temporary before they have serious consequences on the economy. Consequently, since both the government and

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[207] Teorell, "Demokrati eller fåtalsvälde?", 60, 63.
[208] Carlsson, *Så tänkte jag*, 502; Taylor, "The ERM and Maastricht: Sweden Unties Welfare Apron Strings - The Price to Be Paid in Adapting to New Realities,".
[209] Dennis, *500%*, 361-2.
[210] See 42 § of the Sveriges Riksbank Act (SFS 1988:1385)
[211] Dennis, *500%*, 59.

the Social Democrats had committed to the fixed currency, they came under severe pressure to produce sufficient countermeasures to hold the currency fixed. Beyond the psychological shock, hiking the interest rate first from 20 to 75 percent and then to 500 percent in the same day produced the circumstances where choices had to be made and immediate action had to be taken.

In operating under the auspices of the Parliament, rather than the government, with a mandate to both formulate and execute monetary and currency policy, the Riksbank had the independence, expertise and information to frame the crisis situation and its severity. [212]As mentioned above, its only legal obligation toward the government was to consult before major changes in policy. This far-reaching independence gave the Riksbank leverage and authority to influence the government. Dennis writes in his memoirs that the contacts between the government and the Riksbank increased during the fall of 1992 and that "the Minister of Finance needed continuous information on the developing situation, currency flows, comments and assessments from the market, and everything else that was relevant to estimate the situation."[213]

The governor of the Riksbank had frequent consultations with Anne Wibble, the Minister of Finance, but also Carl Bildt, the Prime Minister. Carl Bildt invited Dennis to meetings with the other party leaders on September 18 and with the representatives for the political coalition prior to the second crisis package on September 29.[214] In the first meeting with all the party leaders (including Ian Wachtmeister of Ny Demokrati, and Lars Werner of the Left Party) participating, Dennis reported on what had happened on the financial markets since the summer and accounted for the perspective on policy measures at the Riksbank, including eight requests for the coming crisis package.[215] Anne Wibble, for example, points out that Dennis' briefing made a deep and lasting impression.[216] The day after, Carl Bildt and Ingvar Carlsson issued their joint press release stating that discussions had commenced.

Although Bengt Dennis had primed the coalition partners, it was remarkably hard for the participants to come up with measures that would significantly strengthen the economy. Bengt Westerberg points out that despite initial ideological posturing, it was striking how empty-handed the participants were when it came to real negotiations. The gravity of the situation forced the participants to be creative in their search for measures and set aside many of their core

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[212] Ibid., 202. From 1998 a change in the law transferred the responsibility of currency policy from the Riksbank to the government in accordance with EU law. The government now has the right to decide on exchange rate regime and the Riksbank the responsibility to maintain that regime.
[213] Ibid., 207. My translation.
[214] Ibid., 210-1.
[215] Ibid., 61-3.
[216] Wibble, *Två cigg och en kopp kaffe*, 28. My translation.

issues basically without discussion.[217] The first crisis package launched measures that would decrease the budget deficit with about 2 percent of GNP.[218] That was 1 percentage point less than the 3 percent of GDP that the Riksbank had recommended the government and the disappointing result necessitating a second crisis package.[219] Dennis had also made the argument that a crisis package agreement, if it was ready, should be presented as early as possible on the Sunday, two days later, to give all actors sufficient time for analysis of the agreement before the markets opened again.[220]

Prior to negotiating the second crisis package, the government invited Dennis to meet the party leaders again because "it was important that everybody had the same factual basis."[221] In the briefing, Dennis put the onus on the policymakers stating that the Riksbank had done what it could and that "now it is only the political system that can turn the development around."[222] Bildt also mentions the importance of Dennis for producing an internal devaluation in the second crisis package. When the governor changed the focus from budget deficit reduction to underlining lower employer fees, it convinced Bildt of the importance of this policy measure.[223] According to Ingvar Carlsson, the Prime Minister even suggested that Bengt Dennis would participate in the actual deliberations on the second crisis package, but Carlsson refused to include the Riksbank governor as a "political referee."[224] Although Ingvar Carlsson asked Dennis twice whether the coalition was wasting Swedish resources in vain when entering negotiations on a second crisis package, Dennis assured him of the potential costs involved in recreating credibility for a new exchange rate.[225]

After the second crisis package, the Riksbank was able to lower the interest rates incrementally and the defence of the krona seemed to have been a success. Anne Wibble ordered the Ministry of Finance to come up with a stock of suitable policy measures (50-100 billion krona) in case of emergency or a third crisis package.[226] However, as the pressure on the krona increased again, the coalition partners shifted their attention from constructive negotiation to blame-avoidance, leaving Dennis with no option but to let the krona float.[227] It is hard to believe that the third crisis package that the government unsuccessfully pro-

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217 Interview with Bengt Westerberg, 2004-02-26.
218 Taylor, "Sweden Unveils Rescue Package: All Parties Back Plans to Save Skr 28bn through Benefit Cuts and Tax Rises,".
219 Andersson, "Utformningen av inflationsmålet," 242; Dennis, *500%*, 63; Hamilton and Stuart, "I stormens öga," 134.
220 Dennis, *500%*, 63.
221 Bildt, "Den stapplande vägen till reformer och till Europa," 72. My translation.
222 Dennis, *500%*, 89. My translation.
223 Bildt, "Den stapplande vägen till reformer och till Europa," 72.
224 Carlsson, *Så tänkte jag*, 499.
225 Dennis, *500%*, 89.
226 Hamilton and Stuart, "I stormens öga," 146, 151.
227 Dennis, *500%*, 130.

posed to the Social Democrats would have been enough to calm the markets. The Riksbank admitted that the financial position of Sweden was far worse than in September.[228]

Although the defence of the krona ultimately failed, the Riksbank and its governor played an important role in facilitating the political coalition. What would have happened if Dennis had said "we cannot go on like this?" In posing the counterfactual question, it seems very unlikely that Sweden would have managed to hold on to the fixed currency for so long without his personal influence. In the end, the coalition managed to extend the defence of the krona and provide a successful solution to the banking crisis.

During the fall of 1992, there was also regular contact between the Riksbank and the IMF.[229] With regard to the decision to build a political coalition to back the crisis packages, the IMF played a role as outside broker. The Riksbank, for example, asked the IMF to estimate how big the crisis package would have to be in order to be credible in the financial market.[230] As mentioned above, the Riksbank estimated that a crisis package that cut government expenses with a minimum of 3 percent of GNP would be sufficient in coming to terms with the structural budget deficit and extensive enough to establish credibility for the measures in the financial market.[231] In its contacts with the government, the IMF estimated the budget deficit to 50 billion krona and warned the government against lowering expansion-oriented taxes when the real interest rate was so high.[232]

The Riksbank recognised the importance of the expertise available in the IMF's Article IV delegation, which visited Sweden in September 1992. As Dennis puts it in his memoirs, "the problem for policymakers is that the market always has more confidence in the IMF than it does in anyone else."[233] In the morning of September 18, 1992, the same day the Prime Minister's office invited all the party leaders to Bengt Dennis' briefing of the situation, Ingvar Carlsson and Allan Larsson were invited to meet representatives from the IMF at the Riksbank.[234] According to Ingvar Carlsson, the IMF representatives had declared themselves ready to share their views on the state of the Swedish economy with the Social Democratic opposition. Carlsson regarded the initiative as both positive and unusual, and accepted the invitation. He supposes that the purpose of the meeting was to make the case for strong measures to tighten fis-

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[228] Taylor, "Sweden Admits Defeat in the Battle for the Krona: Sudden Central Bank Move Takes Premier by Surprise,".
[229] Andersson, "Utformningen av inflationsmålet," 242.
[230] Ibid; Dennis, *500%*, 63-4.
[231] Dennis, *500%*, 63-4.
[232] Hamilton and Stuart, "I stormens öga," 129.
[233] Dennis, *500%*, 64. My translation.
[234] Carlsson, *Så tänkte jag*, 488; Dennis, *500%*, 61.

cal policy.[235] Dennis had met the delegation the day before and knew that the IMF delegation was seriously concerned about the deteriorating public finances and recommended rapid reduction of the budget deficit.[236] Although the evidence is only circumstantial, it seems that the Riksbank and Bengt Dennis, with the external help of the IMF delegation, went to great lengths to bring the SAP and the government to the negotiation table.

In retrospect it is clear that the formation of the coalition and the implementation of the crisis packages were decisive in maintaining the fixed currency. They reassured actors in global financial markets of the Swedish political elite's intentions, and proved that they were willing to build a united front and take the necessary measures to run a consistent economic policy.[237] The successful assembly of the political coalition was the action that confirmed the permanent nature of the proposed measures.

In cooperating with the Social Democrats, the government brought national unity behind the measures and this was of important symbolic value both internally and externally. Hart argues that the "most important instrument of crisis management is language. Those who are able to define what the crisis is all about also hold the key to defining the appropriate strategies for [its] resolution."[238] In building the political coalition, the Swedish policymaking elite agreed upon and spoke the same language, and thus had an opportunity to resolve the crisis successfully. However, the dogmatic focus on holding the fixed currency was the wrong strategy. Both the economic and political elite had framed the crisis resolution as hinging upon holding the fixed currency by reducing the budget deficit. Instead of being part of the solution, the fixed and overvalued currency was the problem in that it pushed up interest rates, lowered economic activity and therefore increased, rather than decreased, the budget deficit. It was not before the global financial market forced the government to let the krona float that the restructuring of the Swedish economy could commence.

Although the political coalition ultimately failed, the positive outcome it produced was the political impetus for reform and restructuring of the Swedish economy in the aftermath of the crisis. As Keeler argues, "extraordinary policymaking generally becomes possible only when a macro-window for reform is opened by a combination of window-opening mechanisms, most prominently those related to the size of the mandate and severity of crisis."[239] The Swedish

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235 Carlsson, *Så tänkte jag*, 488.
236 Dennis, *500%*, 64.
237 Andersson, "Utformningen av inflationsmålet," 232.
238 Paul 't Hart, "Symbols, Rituals and Power: The Lost Dimensions of Crisis Management," *Journal of Contingencies and Crisis Management* 1, no. 1 (1993): 41.
239 John T. S. Keeler, "Opening the Window for Reform: Mandates, Crises, and Extraordinary Policy-Making," *Comparative Political Studies* 25, no. 4 (1993): 477-8.

financial crisis provided such a macro-window. While the political coalition assembled a sizable mandate for reforms, the severe financial crisis brought the urgency and fear to accept and implement the policy changes that played an important role in the subsequent recovery of the Swedish economy. According to Carl B. Hamilton, political adviser to the Minister of Finance during the crisis, "the unity showed that the political elite could rise to the occasion and handle the strain." [240] He also points out that without a crisis pushing policy changes, politicians have a hard time being proactive.

Both politicians and financial market actors tend to prefer the short-term gain to what might be the best policy in the long-term. The crisis consciousness formed during the financial crisis was important in that it pushed policymakers to take politically unattractive measures that were good for the long-term prospects of the Swedish economy, rather than focusing on short-term measures satisfying specific interest groups and promoting re-election.

It is problematic for the policymaker to take the appropriate measures in time to avoid crises. Domestically, there is a pedagogical challenge in explaining why extraordinary measures are needed based on a potential threat with vague consequences. There is also a challenge to implementation that is especially pronounced in financial matters. The intersubjective nature of financial markets complicates the implementation of proactive measures. For example, it is hazardous to act on early-warning signals because taking the measure may in itself alert and alarm the financial market and as a consequence trigger the crisis that was to be avoided. Policymakers tend to be reactive and problem-solving rather than proactively avoiding difficulties. The opportunity for decisive intervention lies in the policymakers perceiving that they can and must take action.[241] The Swedish financial crisis created such a transformative moment for the political elite and they managed to convince the population of the necessity of reforms.

7.6. Conclusion

While the previous chapter analysed the global constraints on the state during the Swedish financial crisis, this chapter analysed the agency and policy choices the Swedish state had as it faced those global constraints. The analysis of the three key decisions – i.e. the support of the banks, the defence of the krona, and the building of a political coalition – showed that there were different policy options available in all the decisions. Consequently, the global constraints were not strong enough to leave the state without policy alternatives despite a deepening financial crisis. However, the global constraints on the state in-

[240] Interview with Carl B. Hamilton, 2004-03-10.

[241] See Colin Hay, "Narrating Crisis: The Discoursive Construction of the 'Winter of Discontent'," *Sociology* 30, no. 2 (1996): 254.

creased as the financial crisis deepened and pushed the government to take action to defend its policy choices.

The financial crisis pushed policymakers to take measures that they for different reasons were either unwilling or incapable of implementing without the urgency and high stakes that the financial crisis provided. For example, the policymakers waited for the longest time possible to launch the bank support and build the political coalition in order to defend the krona. The reasons for the slow responses emanated both from underestimating or misperceiving the situation, to overestimating the strength of the Swedish economy and the capability of policy measures to turn the situation around.

The major challenge in the crisis management effort was the phenomenal speed of capital flows in the deregulated financial environment. Deregulation and the rise of global finance had shortened the time available for policy adjustment and policy coordination. The political elite underestimated this environmental transformation and failed to take timely proactive measures to save the fixed currency.[242] As Jervis puts it, "the policymaker who is psychologically and politically unprepared for surprises is almost certain to fail; good generals not only construct fine war plans but also understand that events will not conform to them; doctors must change medications as bodies and microbes react to treatments..."[243] The combination of structural economic weakness, external macroeconomic shock, and a domestic macroeconomic policy inconsistent with a fixed currency would have needed a longer adjustment period than for example the belatedly assembled political coalition could provide. Lack of contingency planning, preparation, and situational awareness exacerbated the shortage of time for policy measures when the financial pressure increased. According to Ingvar Carlsson, the time available for decision-making was longer before the deregulation of the capital market and it has become increasingly important to act promptly and decisively. In his view, policymakers often wait too long to take action and the benefit with early measures is that they usually become less dramatic than the acute crisis management effort.[244]

Had the Swedish government's economic policies in the 1980s been more cautious, the structural budget deficit and the national debt would likely have been more manageable and the Swedish financial crisis might well have been avoided. Even at a later point in time the government could have initiated measures to avoid, or at least manage, the contingencies emanating from the financial markets. For example, the government could have improved its monitoring of the build-up of risk in the financial system. Yet, when the Swedish financial crisis broke out, policymakers merely reacted to the negative develop-

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[242] See, for example, Lindbeck, "The Swedish Experiment,": 1307.
[243] Jervis, *System Effects*, 293.
[244] Interview with Ingvar Carlsson, 2004-02-11.

ments in the financial markets, rather than try to shape the situation proactively.

Admittedly, proactive measures are inherently difficult due to the intersubjective nature of the global financial market. There is always a risk that taking proactive measures will alert financial market actors to problems they were unaware of, which means that the proactive measures may actually have the counterproductive effect of worsening rather than improving the financial situation. According to Westerberg, the political determination to take the necessary measures was always there and grew stronger as the crisis deepened, but there was also frustration that the measures did not have the intended effect. In his view, the problem for the government was that it had difficulty interpreting the character of the crisis and as a result, the premise for the crisis management effort was wrong from the start.[245]

On the surface, the Swedish government reacted in a similar fashion to the banking crisis and the currency crisis. In both cases, it was ready to do whatever it took to defend the banking system and the fixed exchange rate, and the government offered unlimited support whatever the cost incurred to back up the promise. However, beneath the surface, the crisis management approach in the bank support and the defence of the currency was very different. The successful bank support was characterized by pragmatic and adaptive crisis management. For example, policymakers searched far and wide for the best possible solution, and continuously and strategically worked to shape the financial market perception of the effort. The failed defence of the krona, on the other hand, was characterized by a dogmatic and rigid crisis management approach. For example, the conformism among the Swedish political and economic elite regarding the advantages of a fixed currency and the fears of the consequences of a new devaluation both stifled and limited serious analysis of alternatives and contingency planning. In trying to convince the financial market that it was wrong in questioning the overvalued Swedish currency, the coalition made a strong but vainglorious effort that ultimately failed.

The rapidly developing global financial system has made the impact of global finance on state policies more unpredictable and uncertain. This has made it increasingly important for policymakers to continuously adapt policies to the changing circumstances in order to protect and keep policy options open and the autonomy to choose. Otherwise, the risk is that options will narrow and policy autonomy will diminish or be lost. As Cohen puts it, "in an insecure world, most states quite logically would rather minimize their vulnerability to any possibility that their monetary dependence might be exploited. Policy flexibility, in short, is a defense against uncertainty."[246]

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[245] Interview with Bengt Westerberg, 2004-02-26.
[246] Cohen, "Marketing Money," 187-8.

This chapter has provided the agency perspective on the Swedish financial crisis of 1992 and shown that there is room to manoeuvre for state even in the constraining circumstances of a severe financial crisis. The following chapter draws out the lessons and concludes this study.

Chapter 8: Conclusion

After analysing the global constraints imposed on the policymakers and their policy responses during the Swedish financial crisis of 1992, this chapter concludes and draws out the implications of this study. This chapter will summarize the argument made in this study, go through the significance of the research, reflect on the research process and discuss some of the questions this study has provoked.

The argument

This study took the rise of global finance as its point of departure. This feature of supraterritorial relations has had a remarkable impact on the environment in which states operate. As the intensity and extensity of capital flows have increased, states have been forced to adapt their economic policies to the changing circumstances. While there are gains from deregulating financial markets, there are also risks involved. One of the major features of the contemporary rise of global finance has been the many financial crises, and their random and contagious spread around the world.[1] As states have deregulated their financial markets and become more dependent on the operation of global financial markets, they have also become vulnerable to the volatility of capital flows and the inherent instability of the global financial system.

Governments around the world have deregulated their financial markets to extract the benefits of global finance, but at the same time been taken by surprise when encountering the pressures and constraints of global financial markets. They have seemed to be without policy options in defending their economies from the negative effect of global finance.[2] They have in many cases been forced to alter economic policies to satisfy the market sentiment and restructure their economies at great cost for their populations. Only slowly has the awareness of the risks of global finance spread and the demand for measures dealing with these externalities arisen. International institutions, such as the IMF and the OECD, that used to promote financial account liberalization have taken steps to improve the stability of the global financial system. Ultimately, however, states and governments still have to take responsibility and fend for their own prosperity and economic security. The territorial state has to find measures to manage supraterritorial challenges.

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[1] See, for example, Graciela L. Kaminsky and Carmen M. Reinhart, "On Crises, Contagion, and Confusion," *Journal of International Economics* 51, no. 1 (2000): 146.
[2] On the "political construction of helplessness", see Weiss, *The Myth of the Powerless State*, 193.

Although Swedish policymakers were relatively late in deregulating the financial markets, Sweden is now one of the most financially open countries in the world. In deregulating the Swedish financial markets, policymakers opened up the Swedish economy to both the potential benefits and risks of operating in global financial markets. As a consequence of the deregulation, Sweden suffered severely in the financial crisis of 1992 and there was a sense of powerlessness among the policymakers when they had to give up the fixed exchange rate regime.[3] The Swedish financial crisis was the harbinger of the recurring financial crises that struck primarily developing countries in the remainder of the 1990s.

Based on these observations, the primary purpose of this study was to improve understanding of the impact of global finance on state policymaking during a financial crisis. In assessing the impact of global finance on state policymaking during a financial crisis and the extent to which states have policy options despite global constraints, this study developed an analytical framework based on four common suppositions regarding the impact of globalization on state policy autonomy. These suppositions ranged from globalization being insignificant to it causing the decline of the state. In finding these suppositions inadequate to understand an empirical case, such as the Swedish financial crisis, this study suggested a synthesis called constrained choice.

This synthesis makes the argument that states due to the rise of supraterritorial relations in general and global finance in particular now face tighter constraints when making policy choices, and especially when making the policy choices during a financial crisis. The policy space available for policymakers has narrowed. However, there are still policy options available and sufficient policy space at hand for policymakers to influence and shape the direction of state affairs as long as they stay within the policy space. The consequence of this narrowing of the policy space is that it has become increasingly costly to make extreme policy choices outside this policy space. In making similar assessments of a situation and acting accordingly, global financial market actors can effectively veto state policies under specific circumstances.[4] Certain policy choices that were possible before the rise of global finance are now outside states' policy space. An example from this study is the decision to defend the krona, in which it became impossible after the deregulation of Swedish financial markets to run a macroeconomic policy that was inconsistent with the fixed exchange rate regime.[5] Although the government, backed by the opposition, fought fiercely to hold the fixed currency, the global financial market pressure became to strong and the government had to relinquish the fixed exchange rate regime.

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[3] Wibble, *Två cigg och en kopp kaffe*, 39.
[4] Cohen, *The Geography of Money*, 133.
[5] Lindbeck, "The Swedish Experiment,": 1307.

This study assessed the four common suppositions and suggested a synthesis in relation to three key decisions in the Swedish financial crisis of 1992. This study found that the constrained choice approach provides a better understanding of the impact of global finance on state policymaking during a financial crisis. The main criticism of the other four approaches is that they overemphasise either structure or agency. The two structurally-oriented approaches, i.e. the powerless state approach and the forced state adaptation approach, are deterministic in that they perceive the impact of globalization as inevitable and therefore underestimate the actual room to manoeuvre for policymakers during a financial crisis. In the Swedish example, policymakers had more policy options available than these approaches would suggest. The two agency-oriented approaches, i.e. the sovereign state approach and the policy choice approach, argue that globalization is insignificant and that there are only limited constraints on states due to globalization. This study has found that these approaches underestimate the impact of globalization on state policy autonomy in the crisis. In the Swedish example, these fail to account for the structural pressure on policymaking and the limitations on policy choice.

Rather than focusing on either structure or agency, the constrained choice approach focus on the interplay and co-determination of structure and agency. From this perspective, the rise of global finance was possible as a consequence of states' decisions to deregulate their financial markets. As more agents chose to participate in order to extract the gains of liberalized financial markets, global financial markets took on structural features constraining state policymaking. Global finance gave primacy to some actions before others. As the global financial market structure changes so must the states participating in the global financial system. As states adapt policies to the changing context, the context takes on new features, and so on. This continuous action-reaction dynamic propels the development of the relationship between states and the global financial markets.

This study assessed the global constraints and policy options and choices in three key decisions during the financial crisis. The analysis showed that there were global constraints of both material and ideational nature present in the key decision of the Swedish financial crisis of 1992. These constraints narrowed the policy space for the policymakers. However, these constraints were not deterministic but rather indirect and diffuse in their impact on policymakers. The boundaries set for the policymakers changed with time and circumstance. This study found that the global constraints on the policymakers increased as the financial crisis situation deteriorated. The global constraints were most obvious and severe in the decision to defend the currency, while less influential in the decisions to support the banks and build a political coalition.

While there were global constraints present during the Swedish financial crisis, the analysis also found that there were still policy options available in all the key decisions despite these constraints. In choosing policy responses, the government could influence the impact of the constraints. For example, in the decision to defend the currency, the government pursued a dogmatic and inflexible coping strategy of convincing the global financial markets that the fixed exchange rate regime was credible. This coping strategy failed. In the decisions to support the banks and in building a political coalition, on the other hand, the government applied a pragmatic and adaptive coping strategy to increase the efficiency of the measures taken to manage the crisis. This coping strategy turned out to be successful.

While the government pursued different coping strategies in its decisions during the crises, it waited to make its policy choices until it was absolutely necessary. In waiting, the situation continued to deteriorate and the available policy options narrowed as a consequence of the global constraints. Rather than acting proactively and trying to defuse the situation before it became an acute crisis, the government chose to respond reactively. In all the three decisions, the policymakers held on to their policy preferences at length and only chose to adapt their policies under extreme pressures. In the decision to defend the currency, the government only aborted its mission after the foreign reserves had been depleted and the Social Democrats refused to negotiate a third crisis package. In the decision to support the banks, the government only implemented its policy when the payment system risked collapse. In the decision to build a political coalition, the government waited for the longest time possible before settling on the Social Democrats as coalition partner and negotiating a crisis package. In deciding on policy responses very late, the policy options narrowed for the policymakers to the point where they found themselves in an either/or situation, with only two options to chose between. To this extent the government let the crisis development steer its policy responses rather than trying to shape the crisis development with proactive policy measures. The government did not proactively protect its available policy space.

Any crisis is a difficult situation with or without global constraints. Crisis settings are almost per definition settings "in which all options are unattractive and the optimal policy response is either unknown or sharply contested."[6] However, the high stakes and urge to alleviate the pressure trigger some kind of response anyway. Understanding the constraints and options becomes crucial to responding effectively. The constraints on policymakers come from below (from those they represent), from above (from the system wherein they operate), and from within (from their personal abilities and characteristics). These constraints interact and shape the options available to the policymaker. In this account, the focus was on the constraints coming from the growth of supraterritoriality and more specifically from the rise of global finance.

[6] Haggard, *The Political Economy of the Asian Financial Crisis*, 47.

The experiences of the financial crisis of 1992 have had a remarkable influence on policymaking related to global financial markets. The crisis created a consciousness and readiness among the political elites to deal with global financial markets. For example, Göran Persson, Minister of Finance in the Social Democratic government that took power in 1994, expressed the desire to build a self-financing welfare state, so that "no Swedish finance minister will ever again have to travel to New York and London to explain himself to leering twenty-five year old market brokers."[7] The realization prompted far-reaching changes in laws and practices for the affected governmental agencies. For example, a new governmental budget process was implemented to keep a balanced budget, and the Riksbank was one of the first central banks in the world to publish a financial stability report monitoring the risk situation. Although many observers foresaw the end of the Swedish welfare state, there are still no signs of it disappearing any time soon. As Steinmo points out, although the centre-right government faced economic collapse and worked hard to diminish the budget deficit, it actually increased public spending during its term in office.[8] The failure to adapt proactively to participation in the global financial markets and the consequences suffered in the financial crisis of 1992, led the Swedish state to adapt its financial crisis management policies to the new context. As Gelber observes:

> Altogether, it is the modalities of state management which have changed, not the desire for management either by electorates or by governments themselves. What has happened is not so much a loss of 'capacity to manage' as a sensible adaptation to changing circumstances. In these matters the modern state is not so much a mechanism as a chameleon.[9]

The risks of global finance still remain for policymakers in general. One of the few common denominators of financial crises is that "financial disaster is quickly forgotten."[10] Though developed countries such as Sweden, Finland and the UK all faced serious financial crises only a decade ago, it has become common today to perceive financial crises as a "third world" problem, affecting developing countries as they make their transition to full participation in the global financial system.[11] Since developed countries already have made this

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[7] Quoted in Helen Thompson, "The Nation-State and International Capital Flows in Historical Perspective," *Government and Opposition* 32, no. 1 (1997).

[8] Sven Steinmo, "Bucking the Trend? The Welfare State and the Global Economy: The Swedish Case Up Close," *New Political Economy* 8, no. 1 (2003): 39. See also Statistics Sweden, *Yearbook 2002*, 350.

[9] Harry G. Gelber, *Sovereignty Through Interdependence* (London: Kluwer Law International, 1997), 234.

[10] Galbraith, *A Short History of Financial Euphoria*, 13.

[11] Eichengreen, *Capital Flows and Crises*, 240.

transition and adapted policies to better manage the inherently volatile and instable global financial system, they risk becoming complacent and failing to notice new risks as they emerge. In the aftermath of a financial crisis, successful crisis resolution efforts and policy reforms run the risk of becoming the financial equivalent of a Maginot Line.[12] The implementation of the neoliberal policy prescription of adhering to international standards, while improving transparency and supervision,[13] may very well dissuade speculative attacks from a particular direction, but it may also lull policymakers into underestimating the forces and adaptive abilities among global financial market actors. Successful defences against financial crises require constant policy adaptation.

The contribution

This study has made an original contribution to the literature both on the impact of globalization on state policymaking in general and on the Swedish financial crisis in particular. In applying the common suppositions in the globalization literature to a rich empirical case, this study assessed their usefulness and found them wanting. In the last decade, many studies of globalization have suffered some deserved criticism for their level of abstraction and for the making of claims that are either impossible or difficult to confirm. On the contrary, this thesis has attempted to make a constructive contribution to the study of globalization. Using the valid criticism of the common suppositions as a stepping stone, this study synthesises an approach to improve the understanding of the impact of globalization on state policymaking. In that respect, this study has made an original contribution to the general literature.

In using the Swedish financial crisis of 1992 as a case study, this study also makes a contribution to the empirical understanding of this case. There are many studies of the Swedish financial crisis, but remarkably few have systematically analysed the crisis from the perspective of global finance. Consequently, this study has complemented the foci on domestic aspects of the financial crisis with a global finance perspective. In so doing, the study contributed to the filling of this void in the understanding of the Swedish financial crisis of 1992.

The lessons of this study are primarily specific to the circumstances of the examined financial crisis. Financial crises are similar in that they usually follow the same trajectories of mania, panic, and crash, but the specifics are rarely the same.[14] Financial crises happen in specific circumstances and with their own primary decision-makers, laws and institutions affecting the course of events. Drawing far-reaching conclusions from the specifics of the Swedish financial

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[12] This argument is inspired by Edward N. Luttwak, *Strategy: The Logic of War and Peace* (Cambridge, MA: Harvard University Press, 1987), 118-20.
[13] See, for example, Barry Eichengreen, *Financial Crises and What to Do About Them* (Oxford: Oxford University Press, 2002), ch. 2.
[14] Kindleberger, *Manias, Panics, and Crashes*, 13.

crisis will therefore be of a speculative art. However, that is not to say that there are no interpretations and understandings that cannot be applied to another financial crisis and context. For example, in the support of the banks in the financial crisis the crisis management effort rested on the application of available external experiences to the Swedish context. The lessons of this study can be used and applied to a different setting and further focus the conclusions drawn from this single-case study.

The research process

The research process of this study has followed a path of constant re-evaluation of its prejudices, assumptions, concepts and direction. The complexities of globalization, global financial markets and financial crises have had to be dissected continuously, while the intricacies of the different academic interpretations, political battles, laws and institutions forming the understanding of the Swedish financial crisis have had to be penetrated and critically assessed. As the puzzle seemed to be complete, it came apart again and a new approach had to be taken.

As a learning process, this study has been very stimulating in that it provoked new thoughts, insights, and perspectives. Meeting and interviewing some of the key actors in the Swedish financial crisis was also highly worthwhile in that it provided a test of the argument and a glimpse of the reasoning behind certain priorities and choices. Any major event produces assumptions and biases that with time distort the interpretation of that episode. As Lebow reminds us, "'Outcome knowledge' affects our understanding of the past by making it difficult for us to recall that we were once unsure about what was going to happen."[15] The interviews provided valuable accounts of the messiness and confusion of policymaking, especially in a crisis situation, and put the oftentimes neat academic descriptions of the Swedish financial crisis into sharp relief.

In any research process, there are of course some detours made that in retrospect may seem both obscure and unnecessary for the overarching aims of the study. In all, however, the detours made in this study were important in that they assured that dead ends lay ahead and forced reassessment of the central argument. The myth of the linear research process remains a myth.

Looking ahead

This study has generated a number of new questions searching for answers. First of all, the lessons of this study would benefit from being compared across financial crises. This would provide a firmer foundation for the suggested constrained choice approach, than a single case study can accomplish. Comparing

[15] Lebow, "What's So Different About a Counterfactual?,": 559.

other contexts would also improve the understanding of what forms state policy responses to globalization. For example, what is the impact of size, resources, economic structure, political system, institutions, and individuals on the policy options and choices in responding to supraterritorial challenges?

Secondly, in the empirical case of Sweden, it would be worthwhile to examine the aftermath of the financial crisis. As the impact of global finance has continued to increase throughout the 1990s, how did threat perceptions develop among political and economic elites, what priorities did they make and on what grounds and for what reasons did they adapt policies relating to global finance, and how has preparedness to manage financial crisis developed as a consequence of the 1992 experience? Furthermore, what is the impact of Swedish membership in the EU on crisis management capabilities in a financial crisis? Has EU membership increased or diminished vulnerability to financial crisis and what has it meant for global constraints on policy?

Thirdly, the nexus of supraterritorial phenomena and territorially based states poses governance challenges for states in many more issue areas than the financial crisis. As the time-space dimension transforms social, political, economic, and cultural geographies, there will not only be new constraints on governance, but also new opportunities to improve governance and capacity to manage supraterritorial phenomena. This should be a rich field for future studies.

Finally, in the contemporary global financial architecture, states have to fend for themselves. As the rise of global finance continues, the understanding of states' financial vulnerabilities will have to improve in order to develop a more effective policy tool kit. In order to respond to and manage new financial risks as they arise, it will be necessary to improve situational awareness, while facilitating flexible and proactive policy adaptation.

This study started out with a warning issued by George Soros in the late 1980s that later materialized in the 1990s. It seems appropriate to conclude with the ominous warning from the American investor, Warren Buffett, who alerted the shareholders in Berkshire Hathaway that derivatives are "time bombs" ticking away at the heart of the financial system and they should be perceived as "financial weapons of mass destruction, carrying dangers that while now latent, are potentially lethal."[16] We have been warned.

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[16] Warren E. Buffett, *2002 Chairman's Letter*(Berkshire Hathaway Inc., 2003, accessed September 29 2004); available from http://www.berkshirehathaway.com.

List of Interviews

Ingvar Carlsson, Prime Minister of Sweden, 1986-91 and 1994-96; Leader of SAP, 1986-96. Interview held February 11, 2004.

Kjell-Olof Feldt, Minister of Finance, 1982-90; Chairman of the Board of Governors at Riksbanken, 1994-98. Interview held February 10, 2004.

Carl B. Hamilton, Political Adviser to the Minister of Finance, 1991-93; Member of Parliament for the Liberal Party (Folkpartiet) and Member of the Parliamentary Committee on Finance; Under-Secretary at the Ministry of Finance from October, 1993-1994. Interview held March 10, 2004.

Lars Heikensten, Director of the Economic Policy Department at the Ministry of Finance, 1985-1992; Chief Economist at Handelsbanken, April 1992 to 1995; Deputy Governor of Riksbanken, 1995-2003; Governor of Riksbanken from 2003 to the present. Interview held March 2, 2004.

Stefan Ingves, Director of the Financial Markets Department at the Ministry of Finance during the crisis; Director General of the Bank Support Authority (Bankstödsnämnden) from May 1, 1993 until March 20, 1994; Deputy Governor of Riksbanken, 1994-98; presently Director of the Monetary and Financial Systems Department at the IMF. Phone interview held February 26, 2004.

Desmond Lachman, Head of the IMF's Article IV missions to Sweden 1992 and 1993. Phone interview held June 8, 2004.

Åke Lönnberg, Point of contact for the IMF at the Riksbank's International Secretariat (including the IMF's Article IV consultation missions), 1989-1994. Phone interview held on June 9, 2004.

Pierre Vinde, Deputy Secretary General of the OECD, 1985-96. Phone interview held March 24, 2004.

Bengt Westerberg, Leader of the Liberal Party (Folkpartiet), 1983-95; Minister of Social Affairs and Deputy Prime Minister, 1991-94; presently Chairman of the National Financial Supervisory Authority (Finansinspektionen) and Member of the General Council at Riksbanken. Interview held February 26, 2004.

Olle Wästberg, Under-Secretary at the Ministry of Finance, 1991-93; presently Consul General at the Swedish Consulate in New York. Phone interview held March 17, 2004.

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