Nordic economic policies in the 1980s and 1990s

Paper presented to the Tenth International Conference of Europeanists, Chicago, March 14-16, 1996

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Note: Due to bad planning and some unexpected circumstances, this paper is distributed to the panelists much too late. Still, the paper must be considered an incomplete draft, something that I much regret, since the project being reported is already much on overtime. On the other hand, this makes your comments all the more welcome, and they will hopefully contribute to clarification, so that the project can be brought quickly to an end. — This paper relies on much joint work with the project group. As for this paper, the contributions of Lennart Erixon, Juhana Vartiainen, Birgir Björn Sigurjonsson and Bent Sofus Tranøy are particularly appreciated.

Note 2004: The paper was written in 1996 for the occasion noted above. For a variety of reasons, a revised version was never completed. It has been referenced in a number of studies on Nordic political economy, and for this reason I am now making the original version available on the web. At TIK (Centre for technology, Innovation, and Culture at the University of Oslo), more work on these matters will be carried out in connection with projects on globalization and on varieties of capitalism.

Lars Mjøset

Nordic economic policies in the 1980s and 1990s

Notes on social democracy

Two groups like to invoke the notion of the decline of social democracy. Conservative groups, who have in the Nordic setting often been minor parties with much less influence than the social democrats, regularly point to the the failure of social democracy. Left-wing groups on the other hand, often marginalised on the far left side, are ambivalent: they would not mind a decline of social democracy if it led to increasing support for more genuine socialist politics, but as long as this is not the case, they lament the Golden Age of social democracy, in which everything was much better than now. In the international debate, there are numerous voices from scholars sympathetic to e.g. Sweden's programme of a third way between capitalism and socialism, who tend to think that Nordic labour parties have betrayed their successful full employment programmes of the earlier postwar decades.

Social democrats themselves, are manouvering each day in real life politics. Facing normative judgements as those above, they might well respond like Miles Davis, who in his older days was asked by a music journalist why he did not play the old stuff anymore. Reply: «Should I play like Louis Armstrong, in these clothes?» Social democracy also carries new clothes, and it may be hard to determine whether the choice of clothes was that person's choice, or the submission to international fads and fashions. That kind of question has been popular in recent research on how social democracy has managed the economy in the relevant Nordic countries recently.

Below, we summarize the main findings of a project on Nordic economic policies in the 1980s and 1990s.[1] The project was not designed primarily to highlight the fate of social democracy, but given the importance of reformist socialism in the Nordic area, some of our findings may have relevance for this discussion.

Some items not covered in this draft

There is no space here to provide extensive introductory discussion of concepts, theory and method. A less draft-like version of this paper would at least discuss the items on the following list, which is presented here as a service to readers (of this draft) who are familiar with earlier work by the Nordic Economic Policy project. The list covers topics that are dealt with in Ch. 1 of the project's final report.

[1] The Nordic Economic Policy project is the sequel to a similar project which was reported in the mid-1980s. The main publications were: Lars Mjøset, ed., *Norden dagen derpå* [Norden — the day after], Oslo & Copenhagen 1986. English summary: Lars Mjøset, «Nordic economic policies in the 1970s and 1980s», *International Organization,* 41, 3, (Summer), pp. 403-456. A bibliography of the Nordic economic policy project is available in Lars Mjøset, «The influence of regulation theory on Nordic studies of economic policies and social development», *La lettre de la régulation,* No. 6, 1993.

The present project has been supported through 1992-95 by the Joint Committee of the Nordic Social Science Research Councils (NOS-S). Participants have been Jan Otto Andersson, Pekka Kosonen, Juhana Vartiainen (Finland), Lennart Erixon (Sweden), Esben Sloth Andersen, Jesper Jespersen, Klaus Nielsen (Denmark), Birgir Bjørn Sigurjonsson (Iceland), and Ådne Cappelen, Jan Fagerberg, Lars Mjøset and Bent Sofus Tranøy (Norway).

The present summary is based on a book length final report that will be published (in English) later. The project also have produced monographs on four of the five cases. The Finnish monograph was published by Åbo Academy in 1993, while monographs on Iceland, Norway and Sweden are published by the Institute for Social Research, Oslo, in 1996.

— Definition of an economic policy model.[2]

— Presentation of the distinction between four different theoretical approaches, i.e. the economic policy routines and policy goals implied in these four models: the Rehn/Meidner, Keynesian, Scandinavian staple exports and Neoliberal models.

— Definition of five Nordic Golden Age models.

— Definitions of a Nordic Normative Legacy.[3]

— A discussion of structural change as an additional goal, in connection with the neo-schumpeterian notion of «national systems of innovation».

— Definition of internal and external pressures

— Specification of the method of comparison: a case-oriented approach, aiming to uncover patterns of multiple-conjunctural causation to explain changes in economic policies in the Nordic area and the impact of these on the Nordic Normative legacy.

The idealised disappointment cycle

In our earlier studies, we traced the five relatively coherent economic policy models of the Golden Age (in some cases only in the 1960s), and studied the response to the world economic downturn of 1974/5. We found that economic policy routines were maintained with the expectation that the situation would soon normalize. As no such normalization followed, a number of unexpected consequences of economic policies were experienced, and a process of fumbling started. Let us label this a first *disappointment*. In this paper, we shall present a stylized account of three such disappointments. This implies that fumbling has been going on since the late 1970s. The notion of *disappointment* is intended as a specification of this process of fumbling or searching. Disappointment indicates that one pattern of fumbling has failed, and that the search for another solution intensifies. This produces a periodisation that not always fits a periodisation based on the business cycle.

The disappointments are related to both external and internal pressures. Thus, the timing is not the same in each single case. In some cases, there may even be an absence of disappointments over a longer time span. In such cases, per definition, a new coherent model has emerged (cf. the cases of Denmark and Finland, below). In the

[2] Our notion of an economic policy model is an analytic concept: it refers to a coherent system of macroeconomic policies based on international conditions and influenced domestic processes of structural and institutional change.

A model implies that there is a standardisation over time of the decisions made by economic policy makers, implying consensus on how to interpret events and statistics, and on what instruments to rely on given the interpretation of the economic situation. We shall consider a set of routines a *model* if they prevail for more than one business cycle (in the medium term sense, in which the peak to peak period ranges from 5 to 7 years).

Whenever one economic policy model breaks down, one cannot be sure that a new one will emerge. There may be turbulent historical periods in which economic policies operate more or less via trial and error. We shall call this *fumbling* (which also implies searching and learning). In such a period, decision makers may well adopt to international trends of economic policy making. It is an empirical question whether such fumbling ever produces a new coherent model.

[3] The three goals — universal social welfare, full employment and equality — were institutionalized during the first postwar decades. They have also been prominent (at least on the programmatic level) in the institutions of Nordic intergovernmental cooperation (the Nordic council). We dub these goals the *Nordic normative legacy*. The fact that this cluster of norms have been institutionalised does not mean that they have been realised. Rather, it means that they exist as a *pressure for legitimation,* a constraint on political action. The discussion of the crisis of social democracy is to some extent a discussion of the extent to which this constraint has weakened.

following discussion, however, we present an idealized cycle of disappointments. In this stylized version, the timing is homogenous across countries.[4] Inevitably, this cycle fits one country better than the others, and like in many studies of the Nordic counrties, Sweden emerges as the closest fit. The cycle also fits Norway quite well, and the cases of Finland, Denmark and Iceland depart more or less.

The choice of a Sweden-based idealisation is to some extent arbitrary. We could have chosen Iceland is the norm, followed by accounts of how the four other cases deviated from that norm. The choice of Sweden, however, gives more economy to the presentation, as the number of similarities to the other countries multiply compared to the choice of Iceland. Thus, we might hint at a somewhat less relativistic interpretation of our stylized disappointment cycle:

The cycle of disappointments can be seen as an attempt to idealize on the basis of the more general influences on economic policies, while we keep out influences relating to the specific features of the particular nations, features relating to their dominant export sectors, peculiar impact of business cycles, and possible political-institutional ideosyncracies. The idealised disappointment cycle traces the «path-dependence» of economic policies. But such a generalisation is not the goal of our study. To understand each specific case, we need to trace similarities and differences towards the idealised cycle. Only then we can understand the specific timing, and see the factors that influenced this timing.

Thus, each main section below contains three subsections. The first is entitled *generalized experiences*, it traces the general features of disappointment, based on the experience of unexpected effects of the policy solutions of the earlier phase. Cf. the lower level boxes of Table 1.

In the next subsection, we present the *comparative record,* investigating whether all the case countries really experience disappointment, and also whether there were cases of disappointment for different reasons than the general ones.

Thirdly, we discuss the kind of responses that followed. These responses are the new economic policy strategies that produce the experiences that define the next disappointment. Cf. the upper level boxes of Table 1.[5]

In our earlier work, we found that the relatively coherent Golden Age models got into trouble in the high-inflation crisis period of the mid-1970s. This first experience of disppointment in the late 1970s and early 1980s led to a convergence towards a Nordic version of neoliberalism. In this follow-up project, we study two further periods of disappointment. The early 1980s policy of competitiveness lead to the overheating of the mid- and late-1980s. In this period a norm-based policy emerged. These are disappointments connected to the trying out of policies with more marked-based (neoliberal) elements.[6] Although two different versions of neoliberalism have failed, the disappointments have not lead to any sign of a backlash against neoliberal views.

[4] To be more presice, within the project there has been long discussions as to what kind of common perspective should be used to organize the final report. In this paper we try out one proposal, originally put forward by Lennart Erixon.

[5] *Note of warning:* For lack of time, I am not sure whether I have been able in this draft version to organise the material coherently in this fashion. For instance, I am not always able to conduct the analysis I promised to co in the comparaive record setions. I shall have to do some more work on this before this paper can be considered finished.

[6] The emergence of neoliberal views should be understood in a relative sense. The orientation of decision makers was more market-oriented than in the 1970s, but not as strongly neoliberal as e.g. in England and the U.S. We shall not here discuss the social philosophy behind this approach, but specify its implications for economic policies. Neoliberal views imply the following policy advices: (1) deregulation, (2) privatization, (3) cuts in tax and public transfers (hostility towards public sector growth;

The first version of the early 1980s may be seen as a *national* variety. It involved restrictive monetary policies (attempting to push up interest rates) and tight fiscal policies (even in the downturn of the early 1980s). Devaluations, however, often served to secure an expansive economic climate.[7]

Unexpected consequences, such as inflation and various deficits, lead into the period of *norm-based neoliberalism*, emphasizing norm-based exchange rate policies (barring policy makers from the temptation to devalue) and allocative efficiency reforms.[8] The search for closer ties with the EU might be seen as an attempt to consolidate this approach.

That search was further encouraged as in the early 1990s, as it became clear that norm-based policies could not prevent overheating, deep economic setbacks including higher unemployment, and extensive financial instabilities. We shall discuss the extent to which a final EU-based, europeanized neoliberal approach emerges as an «external» solution to these problems.

arguments relate both to crowding out and wrong incentives), (4) hostility towards special interest groups and corporatist arrangements, thus hostility towards incomes policies. — Such neoliberal attitudes also converged with the postulates of *supply side economics,* which is defined by its more specific statements on growth, investments and the capital/labour-relationship. The main point in supply side economis are: (1) Stabilisation policies (demand policies) have no lasting effects on production and employment (shared with neomonetarism as defined below). (2) Priority is given to improved static allocation of resources. (3) Wage formation should be improved and the supply of labour should be stimulated through reforms of (marginal) taxes and by deregulation of the labour market.

[7] This neoliberalism had elements of a somewhat pragmatic *neomercantilism*. The emphasis was on the value of stimulating the exposed sector, but stimulation should not be achived through protective tariffs or the like (in this respect, there was influence from supply side economics), but rather through devaluations and increased wage differentiation that benefits the exposed sector.

[8] This neoliberal approach was influenced by what we shall label *neomonetarism*. Main points were: (1) Priority to the struggle against inflation. (2) Stabilisation policies have no lasting effects on production and employment. (3) Firms and households must be provided with fixed rules of the game (a given exchange rate, a given quantity of money).

Table 1. The Nordic disappointment cycle

PERIOD	Golden age & 1970s	Early to mid-1980s	Mid-80s to early 1990s	Early 90s
ECO-NOMIC POLICY ROU-TINES	* Keynesian counter-cyclical policies (primarily fiscal policies in S, D, N; exchange rate policies and acco-modating fiscal and monetary policies in F, I. * Incomes policies («voluntary» in S) * Industrial support (especially S) * Ad hoc measures after OPEC I (devaluations in S 1976-7, etc)	* Devaluation policies combined with tight fiscal policies in countries with current account and public deficits, exclusive of I (S and D) * Restrictive monetary policies (especially in D and expecially in the late part of the period in other countries) * Deregulation of domestic credit markets	* Norm-based policies — Hard currency policy, in the end ECU-peg) (except I, 1985-88) — Tight fiscal policies to dampen inflation — Low inflation priority — Ban on public borrowing to finance public budget deficits — External deregulations * Allocative efficiency reforms (marginal tax reforms, privatization, deregulation of product markets, public sector cuts) * No monetary stabiliza-tion policy (tied to the har currency policy)	* Floating exchange rates (F, S, [N]) * Tight fiscal and monetary policies to reduce the long term interest rate by raising «confi-dence» and securing conver-gence to EMU.
LEADING COUNTRY	Sweden	Finland	Denmark	EU
ROUTINES SURVIVING FROM EARLIER ECONOMIC POLICY MODELS		Incomes policies (≠ N); Labour market policies	Incomes policies; Labour market policies	Incomes policies; Labour market policies; Tight fiscal policies (to dampen inflation irrespective of effects on confidence); Low inflation priority (irrespective of effects on long term interest rates; Allocation efficiency reforms
EXPERIENCES FROM EARLIER ECONOMIC POLICIES		* High inflation (70s), periodically high relative inflation * Current account deficits (D, I, S) * Loss of market shares (S, D?, F?, N?) * Profitability crisis (S, F?, N?, D?) * High taxes and social expenditures * Public deficits (D, S) * Grey credit markets * Low GDP growth	* High relative inflation * Increasing interest rates * Only temporary gains in market shares * High taxes and social transfers * Grey credit markets	* High relative inflation (early part of the period ≠ D * Relatively low production growth [?] * Current account deficits [≠N], but declining in D * Higher unemployment, first in D, N

First disappointment — late 1970s and early 1980s

According to our earlier analysis,[9] the response to the international 1974-6 downturn implied the continued implementation of earlier routines, perhaps even — in some cases — more generously implemented than earlier. Thus, we do not really see disappointments during this crisis. Only when fumbling starts, that is during the weak international upturn and further during the «second slump» (1980-82), we can trace disappointments.

Generalized experiences

Since this period was already analysed in the earlier project, we shall just refer to Table 1, which quotes the following problems: high inflation (sometimes even high in a relative sense), current account deficits, loss of market shares, a profitability crisis, high taxes and social expenditures, public deficits and faltering growth of GDP.

This period of disappointment coincided with a new set of external pressures, due to the slump in the international economy, following the OPEC II oil shock: the revaluation of the USD and the connected rise in international interest rates, a higher oil price level, and penetration of Nordic markets by cheap manufactured goods from the NICs and Japan.

Comparative record

The account above fits Sweden the best.

Swedish non-socialist governments fumbled 1979-82. A devaluation was conducted in 1981. Fiscal policies (including ambitious labour market policies and defensive industrial policies) were too expansive. Full employment was intact, but Sweden's situation was quite difficult. The old model was accused of creating inflation and large current account deficits. Keynesian concepts (demand management, counter-cyclical measures) were displaced by supply-side concepts such as RULC (relative unit labour costs) and market shares. Even the solidaristic wage policy was accused by Swedish economists of contributing to inflation, and the system of centralised wage formation was accused of creating both the mid-1970s cost crisis and too high wages in the exposed sector in the long run. The full employment goal, however, was not critisized.

In Norway, Labour's muddling through (1979-81) represented an attempt to adjust the Golden Age economic policy model under new and unfamiliar external and internal conditions. Certain regulatory dilemmas (in the housing sector) were unique to Norway, but others (grey credit markets) were similar to problems in Denmark, Finland and Sweden. Political effects of these problems lead to a non-socialist victory in the 1981 elections.

In the 1950s and 60s, Finland's Golden Age model had been a growth oriented corporatism without stabilisation ambitions, thus allowing devaluation cycles. In the late 1970s, a growth-oriented corporatism *with* stabilisation ambitions emerged, including more Scandinavian like priorities, that is, the development of the welfare state, and with a more equal distribution of power between labour/capital organisations as a main basis. The early 1970s was a transition period, which still included elements of the devaluation cycle. The economic crisis of the early 1970s was a catalyst for more consensual economic policies.

Apart from early disappointment in 1977 (high unemployment), Finland did not really experience any disappointments. The Finnish model in this period was relatively expansive. The routines that emerged in Finland since the late 1970s were maintained

[9] «Nordic economic policies in the 1970s and 1980s», Table 4, p. 421.

into the late 1980s, making the 1980s a Finnish Golden Age! Finland had no serious current account crisis.[10] Unlike earlier, Finnish fiscal policies were no more contractive than Denmark's, Sweden's or Norway's.[11] Finland continued on the expansive path in 1983, and there were no major government changes.

The remaining two countries had particular problems: In Denmark, there was a «general feeling of crisis and disaster» in 1979-82. Performance was weak on the most important macroeconomic indicators. Despite the devaluation strategy since 1979 (short attempt to behave like the other Nordic countries), Denmark experienced the fastest increase in unemployment ever seen since the war. Devaluations met with increasing scepticism since they stepped up inflation expectations, leading to high interest rates.

By 1982 — the worst year — Labour was in a situation where it had to pursue both tight monetary and fiscal policies. There was no more room for devaluations, and incomes policies would only work in the very long term. The public budgets had to be tightened strongly, and Labour could not do it. Unable to adress the challenge, the government resigned. The alliance Labour/Radical Liberals had dissolved. In particular RV required harsher measures to reduce the growing budget deficit, the escalating national debt, etc.

Iceland's economic policy model entailed very expansive policies, creating instability. This conforms to the generalisation that the Icelandic economy has the largest swings in the region. Many of the novelties introduced in economic policies were contradictory. No effective strategy was devised to tackle the challenge of reducing domestic sources of instability (sudden fall in the capelin catch, uncontrolled money and credit markets). Fiscal policy continued to be expansive (to 1982), and there were some modifications in wage indexing. Credit expansion was totally out of control (investment boom) despite indexation of credit terms (positive and rising real rates of interest). Iceland was torn between the need to tighten policies due to the challenges created by OPEC II, and the pressure to expand, given booming catches in 1980 and 1981 (thus, Iceland felt positive impulses while the other countries faced deteriorating external conditions).

In 1982 — when conditions improved elsewhere — there was a drastic fall in fish catches, declining exports, and a severe profit squeeze in the fisheries sector, while the rate of inflation continued to rise. (Yearly inflation rates were around 45 percent 1978/9, ca. 50 percent 1980-82.) The standard procedure followed: devaluation of ISK and reduction of price compensations promised to wage earners. Wage pressure mounted. Because of large debts — given profit squeeze — the fisheries sector could only tolerate the high real interest rates if the exchange rate depreciated with falling export prices, and incomes policies curbed the domestic wage-price spiral. Inflation escalated to 83 percent in 1983. The wage-earner-biased government naturally lost the 1983-elections.

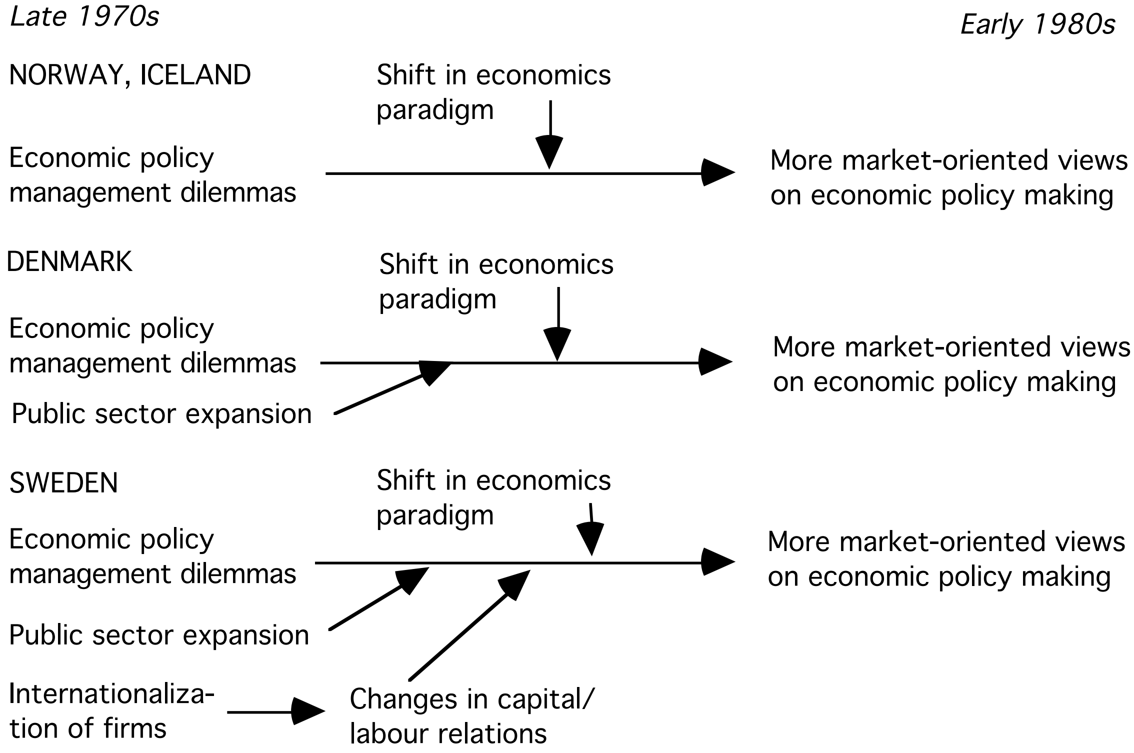
Responses

The emergene of neoliberal, more market-oriented approaches to economic policies was a main part of the response to the problems traced above. Figure 1 summarizes the factors behind the spread of neoliberal attitudes in Nordic economic policies.

[10] *Norden dagen derpå,* p. 274, arguing that one reason is possibly the structural changes analysed in *Norden dagen derpå,* Ch. 4.5.3. Also arguing (cf. Figure 4.6.2) that the countercyclical nature of Eastern trade was the main reason for the mild pressure on the Finnish model.

[11] *Norden dagen derpå,* p. 275 for a discussion of whether this was a conscious change. We argue that the conditions were very favourable, rather than that the model had changed: if the current account deficit had been larger, policies might very well have been tighter too.

Figure 1. The neoliberal turn compared


Late 1970s
Early 1980s
NORWAY, ICELAND
Shift in economics paradigm
Economic policy management dilemmas
More market-oriented views on economic policy making
DENMARK
Shift in economics paradigm
Economic policy management dilemmas
Public sector expansion
More market-oriented views on economic policy making
SWEDEN
Shift in economics paradigm
Economic policy management dilemmas
Public sector expansion
More market-oriented views on economic policy making
Internationaliza-tion of firms
Changes in capital/ labour relations

We can trace three different causal constellations. In all of them, the paradigm shift among professional economists exerts influence as an intervening variable.[12] In the cases of Norway and Iceland, the paradigm shift interacted mainly with the regulatory dilemmas that had evolved through the period of high inflation. In Denmark and Sweden, criticism of large-scale public sector expansion was an additional factor, reflecting larger public sectors, larger structural budget deficits and higher taxes in these two countries. In Sweden, finally, also the internationalisation of firms played a role, since it alters the balance between labour and capital in labour's disfavour. We find that other possible causal factors are not of major importance, this goes for the variables emphasised by the power-resource approach (except the Swedish changes in the capital/labour-relation), and certainly for the political colour of the government. Except in the case of Sweden, internationaliation excerts an influence mainly through the shift in economics paradigm.

Finland stands out as having no significant neoliberal turn in this period. Whatever there was of professional reorientation among Finnish economists had few practical effects, as there were no strong impact of neither regulatory dilemmas nor of public sector expansion. We shall discuss below how the neoliberal turn came to influence Finnish developments at a later stage.

Let us now turn to the specific economic policy responses. Generalizing quite a bit, we find that the major response was a *national neoliberalism,* marked by (1) a policy mix in which a tight stance in monetary and fiscal policies was coupled with

[12] This should be related to the literature on the «political power of economic ideas». There is no space or time to do that here.

devaluations (the devaluation routine had been introduced somewhat earlier); (2) the start of a process of structural change, the internal deregulation of credit markets.

All Nordic countries now entered a road away from Keynesianism. Countercyclical fiscal policy was primarily part of a strategy to stimulate the open sector (mainly in Sweden and Denmark), and steps were taken to disarm monetary policy (mainly in Denmark). To the extent that earlier Keynesian countries had any inclination towards generally expansive economic policies, this was not due a Keynesian conviction, but due to a higher degree of freedom caused by few macroeconomic problems (primarily Finland and Norway). The road away from Keynesianism became more obvious in the mid-1980s.

Norway and Sweden increasingly followed Iceland and Finland in turning to devaluations (break with their earlier routines). Even Denmark did, despite its legacy of fear against inflation. But due to this brief and negative experience, Denmark also became the first to establish a hard currency approach.

The parallells between the Finnish, Norwegian, and Swedish cases indicate the «Scandinavisation» of Finnish fiscal and monetary policies, together with the «Finlandisation» of exchange rate policies all over the Nordic region. It is possible to draw a distinction between coherent and incoherent models.

In Sweden, the 1982 devaluation started off a period which seemed coherent, but which gave rise to major problems in the second half of the 1980s. In Norway, non-socialist economic policies involved neutral fiscal policies, decentralisation of wage settlements countered by small devaluations and expansionary monetary policies, a constellation that could not be sustained for long. In Finland, a rather coherent model of economic policy making had emerged. In the case of Denmark, Labour's approach before 1982 proved incoherent, but the extent to which the new approach was coherent did not become clear as soon as in the Finnish case.[13] The Icelandic model has, in fact, always been a chain of more or less incohernt sequences.

When Labour came to power in Sweden in 1982, the government launched the *Third Way,* promising to transcend both Keynesianism and Monetarism, enabling Labour to simultaneously reduce the structural component of the public deficit, reduce the current account deficit, raising investments/competitiveness and defend full employment.[14] The 16 percent devaluation in 1982 was the main instrument of the strategy,[15] coupled with tight fiscal policies in the 1980s recovery. The Third Way did not imply a changing emphasis on the various goals of economic policy. It was response to the problems quoted earlier: structural public deficits, massive current account deficits, profitability crisis, and dramatic losses of market shares in the late part of the 1970s. Improving Swedish competitiveness by a devaluation was a way to avoid that current-account improvements — through deflationary policies — lead to higher unemployment. Thus, we dub this a nationally oriented neoliberal approach. Only in the

[13] In 1986/7, our judgement was that Finland had the only Nordic economic policy model that had stabilised through that early 1980s instability, Mjøset, «Nordic economic policies in the 1970s and 1980s», p. 446. However, in retrospect, even Denmark's search was about to lead into a more stable solution (one involving mass unemployment though). Strictly speaking, that period of stability started only after the fading of the 1985/6 boom.

[14] K. O. Feldt, *Den Tredje Vägen,* Stockholm 1985.

[15] Note, however, that devaluations *might* be seen as a Keynesian instrument to raise aggregate demand by lower RULC leading to higher market shares. But the 1982 devaluation was non-Keynesian in the sense that its expansive effects were counteracted by tight fiscal policies — the aim of this mix was to raise profitability and shift resources to the open sector.

latter half of the 1980s we find a marked break with the interventionistic Swedish model.

In Norway, the new Conservative government (fall 1981) pursued public spending cuts, tax-relief for high-income groups, and deregulation. Two years of tight policies brought unemployment higher than anytime during the 1970s. The new coalition government (Willoch II) in June 1983 began to concern itself more with the welfare state and the fate of rural areas, pursuing more expansive policies. As for the policy mix, the main changes did not occur during the Willoch I government. Fiscal policy was neutral, and there were attempts to counteract expansion by tilting up the nominal interest rate. Willoch I acted on certain of the regulatory dilemmas, liberalising the housing sector,[16] stimulating the stock market. In the upturn from 1983, Norway pursued several smaller devaluations (routinely used to «correct» competitiveness after decentralised bargaining), with procyclical fiscal expansion (Sweden, in contrast had two large devaluations, with tight fiscal and monetary policies). Norway's monetary policies were expansive from 1984 and onwards. Sweden and Denmark had substantial problems due to the large current account deficits. Norway, however, pursued austerity without an external deficit.

In Finland, the OECD structural budget balance indicator shows that fiscal policies were counter-cyclical in two out of three years. This signifies the «Scandinavisation» of Finnish economic policies. The older «cameralist» tradition in Finnish economic policies had been the claim that spending should match incomes from taxation. This kind of budgeting had now become a thing of the past.[17] Monetary and incomes policies also proceeded according to routines, and it should also be noted that Finnish business cycles were quite stable.

The resignation of the Danish Labour government in 1982 implied an opening for a brief neoliberal shock treatment. The Radical Liberals (RV — generally the moderating middle force in Parliament) switched to support the Conservative austerity offensive. But after a real decline in public spending 1983-4, public spending grew in real terms. RV reverted to its moderating role. Since 1983, the advantages of the new mix of exchange rate policy and wage policy (moderation achieved already during Labour rule) could be reaped, leading on to a boom period.

In Iceland, a more firmly neoliberal (neomonetarist variety) government was inserted after the election of mid-1983. Developments 1983/4 were mainly marked by the interaction between exchange rate policies and incomes policies, involving very heavy mobilisation relating to incomes policy dictates.

But devaluations 1982-3 were less effective as policy instruments than earlier. Most financial assets had now been indexed. Real interest rates were high and positive, and the whole economy was strongly indebted (especially the fisheries sector, due to large investments in freezer trawlers). Although Iceland is the smallest and most «deviant» (with a business cycle influenced by fish catches and prices) economy of all the Nordic ones, it here proves to be in an avant-garde position. The turn to high real interest rates came much earlier. The problem of debt deflation would strike the other economies, with the exception of Denmark, later.

Let us now turn to the second feature of the response to the first disappointment, the internal deregulation of the financial system. We shall deal with three aspects of this process: 1. Lifting of quantitative restrictions (introduction of more market-oriented

[16] The differences to Sweden and Finland is analysed in our final report.

[17] Jukka Pekkarinen & Juhana Vartiainen, *Suomen talouspolitiikan pitkä linja* [The long line of Finnish economic policy], Porvoo 1993. [Revised edition and Swedish translation coming up in 1996.]

measures). 2. Changes in the market structure (competition policies). 3. The fact that there were certain adjustment lags in the relationship between structural changes and changes in monetary policies.

Denmark started the internal deregulation of its financial system already in 1983, while Finland, Norway, and Sweden all started later. In all the countries, the deregulation of financial markets took place gradually. The Finnish case was extreme, as deregulation was never analysed seriously or even stated in any official policy document. But in none of the countries, parliamentary debates ever raged high over these issues, and the Central Bank had strong influence over the outcomes.

Let us consider the *lifting of quantitative restrictions* in the mid-1980s. First, both Finland, Iceland, Norway and Sweden retained primary reserve requirements, but they abolished other kinds of (e.g. supplementary) reserve requirements. Second, rules as to how funds should be placed (such as e.g. purchases of state-issued and state-guaranteed bonds) were abolished. In Sweden, this happened already in the late 1970s in connection with the budget deficits. Third, as for the banks' option of borrowing in the central bank (quotas, involving penality interest rates on overdrafts), existing systems were modified, being made less penalizing. The case of Denmark is special, since Denmark had only had such restrictions since the worsening of the current account problem in the late 1960s. Denmark had less barriers to deregulation than the other countries, whose financial systems had been tightly regulated through the whole postwar period. In Denmark, quantitative restrictions on bank lending, etc. were dismantled already 1980-82.

Fourth, the introduction of open market operations indicated a more market-oriented method of central bank control of the money supply. Again, Denmark deviates: Efforts to open up the Danish bond market in the early 1970 had failed.[18] The Danish bond-market has always involved a vast market for secondary trading. Given the enormous size of this bond market, the Central Bank has little chance of influencing the interest rate, so in fact the Danish Central Bank had given up open market operations in the mid-1970s.

In all the cases, these moves responded to the earlier emergence of financial institutions (although the size of the grey market was perhaps exaggerated) wholly or partly beyond the control of the Central Bank. Through these markets, quantitative restrictions could be evaded. One of the motives behind internal deregulation was to make the capital market work more smoothly given the early 1980s situation with strong current account and public deficits. (But even Norway, with no huge external deficit deregulated in the mid-1980s.)

In Norway, almost all restrictions on lending had been repealed by January 1984. Primary reserve requirements and open market operations were then the authorities' only remaining credit policy instruments. The same was the case in Sweden by 1985. In the Finnish case, internal deregulation had been completed with the repeal of lending quotas and penalty interest rate on overdrafts in the central bank by 1989. In Iceland, monetary control by the Central bank in the mid-1980s would be based on active policy rules for reserve and liquidity requirements (which allowed inflationary taxation until 1986), penalty interest rates on overdrafts and guidelines to commercial banks.

Let us now turn to changes in the structure of financial markets (some of which reflected changing competition policies). Some changes followed from changes in legal

[18] Denmark had already opened up large parts of its capital market as a consequence of the EU membership in 1973. But as Danish bonds had become extremely attractive, a temporary ban on the sale abroad of Danish government bonds had to be reintroduced in 1979.

regulations. In 1984, Norwegian banks were left much freer to establish new branches and offices. Foreign banks were allowed entry at about the same time.

Just as important are changes in the execution of existing regulations. Let us consider functional desegmentation. Until the mid-1980s, the Danish system had been marked by a specific pattern of segmentation: mortgage institutions provided credits for housing and business buildings, insurance companies provided all varieties of insurance except for pension insurance, which was taken hand of by pension funds and banks. Banks, furthermore, provided loans to businesses and to consumers. This division of labour was fixed for a long time, also implying that the largest actors in each group were well established. In the mid-1980s, however, this division of labour dissolved as regulatory practice became looser. In 1982, mortgage institutions began to compete with banks in the field of consumer credit. Holding companies (that had already been put up in order to evade quantitative restrictions in the late 1970s) owned by other financial institutions, engaged in new lines of business. The goal was «financial supermarkets». The regulating authorities, however, be it the central bank or the state, decided that the legislation ensuring segmentation should not be applied to these holding companies. We do not know whether the political level was involved, but in any case these decisions — even if they were made by bureaucrats — were genuinely political. The results of this desegmentation — credits were extended very liberally in the middle of the 1980s — led to a difficult learning process for Danish monetary authorities, for the politicians, and for the financial sector.

Regulation may also take the form of self-regulation, without state involvement. It has been argued that an important preface to the Norwegian banking crisis was a change in practices within the banking community (the emergence of a competition-/efficiency discourse; independent responsibility for a profitable result at the branch level), increasing interbank competition as well as competition between banks and other finance institutions. Such changes in the internal management strategy were not matched by more coordination by the head offices of the banks. The major result was an increased willingness to take risks. The same applied in Finland and Sweden.

Finally, particularly in Norway and Iceland, there was in addition privatisation — or reorganisation — of financial institutions earlier run by the state.

Let us consider adjustment lags, more specificlly, the timing of internal deregulation relative to certain other economic policy measures. As various restraints and quotas earlier used to regulate the credit volume were cancelled, one would expect that the determination of the interest rate (the price of credit) should immediately be left to the same market forces. However, in several of the cases, regulations still allowed the central bank to determine the interest rate. Thus, in Norway, there was an «interrim» period in which the interest rate was still an administered price. [The cases of Sweden and Finland must be checked.] This was one of the factors behind the persistence of negative real interest rates. In Denmark, Central Bank influence over the interest rate only extends to the money market interest rate, and to interest rates that are charged by the banks. The real interest rate never became negative. There was nothing like the Norwegian interregnum of low interest rates, although the Central Bank allowed more accomodating monetary policies through the first years of the Conservative-led government. As for Iceland, most financial assets were indexed in the early 1980s, due to its hyperinflation experience. It seems, however, that not even a positive real interest rate could barr the many options for expansive credit policies (state support and manipulation of various catch and price-regulation funds).

In Finland, the timing of liberalisation was ill conceived. Central bank control over the interest rate was ceased in 1986, following a strong boom, while at that time most economists did forecast a slowdown of the economy. Furthermore, the private banks' cartel on the deposit side had not yet been dismantled (similar in Norway and Sweden). This ensured a steady flow of cheap deposit funds for the banks in the late 1980s, while they were already able to channel these funds into more high-yielding and risky investments.

Another important element of inertia was the absence of tax reforms in the period. In all the countries major changes in the tax-system came only in the late 1980s. Fiscal incentives such as tax deductibility of mortgage interest payment were still generous before that. By leading to negative post-tax real interest rates, these incentives encouraged further indebtedness.

This summary indicates that in matters of internal financial deregulation, Denmark was a pioneer, while Iceland and Finland were laggard. This pattern also comes out when we consider external deregulation. Denmark made the turn to a hard currency line already in 1982, much earlier than the others. To bolster the credibility of the hard currency approach, it was decided to relax the remaining restraints on foreign capital flows. In May 1983 all transactions in bonds and shares — in *and* out of the country — were permitted and firms were allowed to borrow unconditionally abroad. The final restraints on residents' options of buying financial assets in other countries were lifted on January 1, 1984. Further liberalization of currency restrictions on June 1, 1985, implied that all financial assets traded on the stock exchanges were given free. Finally, in 1988, firms and households could freely chose whatever currency they wanted to use for their financial operations.[19] In each of these steps, Denmark was ahead of the other Nordic countries. There were a few early moves also in the other countries, but the main decisions came in the latter part of the 1980s, relating to the second disappointment.

Adjustments through the early 1980s crisis led the way into a major boom period in all the countries. The mid-80s contains a major paradox: the strongest postwar consumtion boom occurred during a decade of anti-Keynesian proclamations about holding back both private and public consumption in favour of private savings and the exposed sector.

The mid-1980s involved several external stimuli: The international recovery generated by Reagan's deficits immediately favoured the raw materials industries, in Sweden, as in Finland and Norway. Revaluation of the dollar implied advantages for Nordic wood producers and Swedish car companies in their competition with North-American producers. As for producers whose products were invoiced in dollars (e.g. wood pulp, oil), the rising dollar implied rising profit margins. There were both instant and delayed multiplier effects from export boom. In Norway, exports and industrial production picked up, and increasing oil revenues before 1986 enabled the Conservative governments to pursue tax cuts and stimulation of the stock market.

As for Sweden, the export boom continued through to the late 1980s. Rising demand pushed prices up, compensating the declining dollar from 1986. In addition, the international investment boom benefited Swedish engineering industries. The combination of high capacity utilisation and high profits boosted private investment demand, which was also spurred by deregulation of credit markets. The recovery was strengthened by devaluations, especially in Sweden, plus favourable terms of trade (Sweden & Finland), and by the construction of currency baskets (Sweden followed the dollar down in the late 1980s).

[19] Peter Erling Nielsen, «Danmark», in Marianne Stenius, ed., *Penningpolitik i Norden,* Lund 1987.

Through the 1980s, various Icelandic governments tried to apply the neoliberal guidelines earlier written into the EMA-programme. Monetary and credit policies were designed to keep real interest rates high enough to stabilise the domestic credit market with a view to opening markets for international competition and free flows of capital, which was then believed to be the precondition for a stable exchange rate regime. Iceland experienced very harsh economic policy measures 1983-4, but external conditions turned favourable in 1985-7. With favourable terms of trade trends 1986-7, money flowed into the economy, so the commercial banks found no rationale for restrictive behavior. In Iceland, higher export prices and good cod catches spurred a new investment boom in the indebted fisheries sector, despite high rates of interest. However, before any significant moves towards financial deregulation had been made, a new external shock destabilised the Icelandic model.

In Norway, internal deregulation lead to unprecedented credit explosion due to repressed demand for loans and competitive lending by banks, also fueled by large short term capital inflows in 1982-4. Private consumption exploded between 1984 and 1986. Full employment was attained in 1986, but with a large deficit on the current account and unsustainable household behavior. Household savings went negative, real estate prices increased by a factor of 1.5 through the period 1980-87. Monetary policies were highly procyclical. There was also a dynamic relationship between non-intervention in incomes settlements, devaluations and absence of wage moderation. It was realised that the lowering of (marginal) tax rates had quite small effects on wages. Thus, the Willoch II government conducted many small devaluations, adjusting external to internal price developments. These devaluations would modify the results of wage settlements. Fiscal policies seemed to have played no major role here.

Swedish economic policies had changed since the 1970s. At that time, generally expansive fiscal policies would serve to lift Sweden out of the crisis, while *ad hoc* measures (devaluations) were used to control the negative effects on the current account. In the 1980s, in contrast, other instruments than expansive Keynesianism were used to get Sweden out of the crisis, while countercyclical policies (read: restrictive fiscal policies) were used to avoid overheating and sustain the transfer of resoruces to the open sector. Keynesianism was not offensive anymore. Furthermore, serious attempts to cool down the economy were not made until the late 1980s. Sweden succeeded during the second half of the 1980s to maintain full employment despite less emphasis on labour market policies.

Deregulation, together with high growth of real wages and increasing working time (in contrast to most other OECD countries), spurred Sweden's private consumption boom in the second half of the 1980s. As a consequence, employment in the private service sector increased its share of total employment. Fiscal policies were not restrictive enough to contain the overheating tendencies in the 1980s. Moreover, the export sector did still flourish due to an international investment boom and favourable terms of trade effects for the wood industries. The Third Way boiled down to a combination of devaluation and incomes policies. By the mid-1980s, Sweden's *Third Way* celebrated as a success. But the devaluation strategy interacted with external events to generate a wage drift/wage compensation process. But both the government *and* the central trade union movement lost control over wage formation in the late 1980s.[20]

[20] Thus, in the late 1980s, the non-socialist parties turned from reluctant admiration to criticism of *The Third Way,* which was now blamed as the main cause of the «speculation and casino economy» which was again the root of the 1990s economic crisis. But there are no indications that a non-socialist government would have been able to apply restrictive measures any earlier than Labour did. Furthermore,

As for Denmark, its policies were particularly austere in 1983-4. But then followed booming years, with high GDP-growth 1984-6. Despite the hard currency commitment since 1982, monetary policies were relatively expansive since 1983. Except this, all policies were tight. The general idea was that reduced inflation would lead to increased private sector employment, a reduced public deficit («crowding in» via tight fiscal policies), and a balanced current account. The two deficits (public and external) would be managed, even with a fixed exchange rate.

The Danish budget balance turned to surplus in 1986, much faster than expected. Incomes policies towards the public employees was successful, and above all tax-pressure was simply increased (against the promise of the government). However, the government failed to correct the current account deficit. Consumer demand adapted much faster than expected to the falling (real) interest rates and increasing personal wealth. There was a credit boom similar to the other Nordic countries, due to deregulation and desegmentation. Funds returning from the grey financial markets spurred booming demand for credit. As domestic demand accellerated and the savings rate declined 1985-6, private consumption (catching up from a major slump in consumption 1980-82), production, enmployment, and property prices grew in this optimistic «Schlüter boom». Thus, despite the international upturn and terms of trade improvements in 1985/6, there was a record currenct account deficit, as imports of consumer goods surged. On the positive side, this reduced unemployment somewhat. Growth of employment in the manufacturing sector was high by international standards, investments soared, and competitiveness (ULC) increasedy by 20 percent.

Second disappointment — mid-1980s

Can the mid-1980s be seen as a period of disappointment? Unlike the two other disappointment periods (Table 1), this was a boom period (as we saw above), not a period of economic crisis. The early 1980s disappointment went together with an international slump, and the problems of the early 1990s again emerged in a situation of economic crisis. This difference may explain why the disappointments of the mid-1980s seem to appear in a gradual way.

Generalized experiences

According to Table 1, the following problems were felt: high relative inflation, increasing interest rates, gains in market shares turn out to be only temporary, high taxes and social transfers, and grey credit markets. (Note that out of these problems, four of five are the same as in the first period of disappointment.) As for the international business cycle, there was the first out of two cyclical peaks, the latter came in the late 1980s, and there was no major crisis inbetween, but while the first was mainly based on a US boom, the latter also included a general European boom. In late 1985 and 1986, there was the oil price slump and the «soft landing» (devaluation) of the dollar. As for structural changes, the deregulation of international credit and currency markets at that time began to be generalised in Western Europe.

There seems to be two ways in which disappointment can be understood in the mid 1980s. Although a gradual transition, there was a switch from the *national* to the

the non-socialist critique obscured the fact that already Labour had moved towards the norm-based approach.

norm-based version of neoliberalism. This switch was based on the realisation that the national variety no longer works, and particularly the new view that devaluations did not spur competitiveness. The term norm-based policy indicates a non-accomodating policy, in contrast to discretion. Secondly, as we have already indicated, in all the countries, investment and consumption booms led to problems of overheating (including regulatory problems w.r.t. the credit volume), and related problems of achieving wage moderation (regulatory problems in the area of incomes policies). It was gradually realised that consumption booms and asset price inflation were symptoms of a failure of economic policy management. The problems led policymakers not just to pursue a hard currency line (that is, joining Denmark, the avant garde in this respect), but also to implement tax reforms, and other allocation efficiency reforms, as we shall see later.

Let us first consider the mid-1980s booms. While Iceland's political economy has been used to dramatic swings, including consumption booms when times are good, economic development had been more stable in the other Nordic countries. Through the 1980s, however, all of them experienced both consumption and investment booms of a greater magnitude than ever since the Golden age (with the possible exception of the investment boom of 1973-4). These booms lead to huge increases in the value of assets such as houses and shares.

Table 2 synthesizes information on the growth of real private consumption expenditure and net household savings rates.

Table 2. Dating of consumption booms

	D	F	I	N	S
Above OECD-average growth of real private consumption	1985-6	1986-9	1985-7	1985-6	1986-7
Strong decline of savings rate	1985-6	1988	1987	1985-6	1987
Negative savings rate	Not ever	1988-9	A lot	1985-8	1987-90
Consumption boom years	*1985-6*	*1988-9*	*1985-7*	*1985-6*	*1986-7*

Source: OECD, *Economic Outlook.*

Through the 1980s, in all the countries, stock markets recovered and grew more important than earlier (again Denmark may be an exception). The liberalisation of the stock market — interacting with the deregulation of the capital market — involved increased volumes and prices, increased ability to back bank loans with these securities, which in part went back into the stock market, which increased prices further, generating a spiralling development. The combination of a distorted tax system, high marginal taxes, and relatively high inflation explain the propensity to borrow. Borrowing was also stimulated by a feeling of everlasting good times, spreading in the long recovery/peak sequence from 1983 onwards. The lending explosion amplified the effects of exchange rate devaluation on stock market prices. The negative real effects and the instabilities created by this boom were not seen until the late 1980s.

Table 3 contains some rough information on share index numbers.

Table 3. Two stock exchange booms of the 1980s

Share price index doubles	Consumption	Share price index	Start of

	Early 1980s	booms	doubles — Late 1980s	decline
D	1981-83 (2 years)			
	1982-85 (3 years)	1985-6	1987-91 (4 years)	1992
F	[Data missing]	1988-9	1985?-89 (4 years)	1990
N	1982-84 (2 years)			
	1983-85 (2 years)	1985-6	1988-90 (2 years)	1991
S	1981-83 (2 years)			
	1982-84 (2 years)	1986-7	1986-88 (3 years)	1989

Source: Nordic Yearbook of Statistics, various volumes.

We see that towards the end of the early 1980s downturn, there was a major surge of share prices. This boom faltered at about the time the consumption booms caught on. In Denmark and Norway, the consumption booms fits nicely inbetween two stock market booms, and the second, late 1980s stock market boom coincides with a tightening of policies. In Finland and Sweden, the late 1980s stock market boom overlaps with the consumption booms, that is, the stock market boom is part of a pattern of overall expansion. (Internal financial deregulation is simultaneous with consumption boom more than with the share price boom.)

These nuances regarding timing, however, do not disturb the general conclusion here: unprecedented consumption and investment booms contributed to the overheating of all the Nordic economies.

Comparative record

Differences in the timing of consumption and investment booms were discussed above. There are significant differences in the economic development of the Nordic countries in the latter half of the 1980s. Norway and Finland may be seen as extremes: In Finland there is a feeling of everlasting good times, as the economic policy strategies have not met with any disappointments since the late 1970s. Norway, on the other hand, now became the victim of its dependence on oil: the combined oil price/dollar slump in the winter of 1985/6, immediately reversed the external conditions of the Norwegian economy. It became clear that Norway’s business cycle was now more influenced by the oil price and the dollar exchange rate than by the Western European cycle. One of the external factors that created problems for Norway lowered energy costs, thereby improving the situation for Sweden and Finland, but — surprisingly perhaps — not for Denmark. Sweden is thus closer to the Finnish case, while Denmark is closer to the Norwegian case.

As for Finland, the 1979-88 period was the economically most successful decade in Finnish history. Having been carried lightly through the 1980-82-recession, Finland benefitted from the Western OECD-based recovery in the mid-1980s. A good bit of luck helped keep the economy on a stable growth path during almost a decade. There were no major disputes over economic policies. Inflation gradually came down, unemployment stayed at 5 percent, and terms of trade improvements counteracted balance of payments problems (despite faster growth than in the OECD area). Monetary policies were tight, incomes policies non-conflictual, and devaluations absent. There was no mid-1980s disappointment. Both external financial deregulation and consumption boom/overheating mainly belong to the late 1980s.

In 1986, external and internal developments weakened Norway’s non-socialist government. With the reverse oil price shock, they were forced to pull the breaks, while the rest of the West European economies could continue their upturn. Failure to implement a tax reform and loss of control over credit policies were main criticisms by the OECD.

But even Denmark experienced disappointment in 1985/6. The current account deficit exploded, GNP growth stagnated, while the rest of OECD-Europe grew at around 3 percent. Employment also stagnated. Danish firms lost market shares both in the domestic market and in international markets.

There were certain differences in the mechanisms behind the consumption and credit booms. As for the housing sector, real estate prices accellerated in the mid-1980s in all the countries. It seems, however, that Norway is the only country (among our five) in which the deregulation of housing rents played a major political role. This regulatory dilemma rooted in the high inflation, which created large discrepancies between two segments of the housing market, that is between the cooperative segment (with regulated prices) and the private segment (where owners could reap inflation gains).[21] The Willoch government's deregulation led to soaring demand in the housing market in the mid-1980s, and similarly to demand for loans, since rules of tax deductibility for mortgage payments were still unchanged. The boom spread also to other kinds of property. This contributed to a spiral of increasing security values, increased borrowing capacity, increased credit volume (and consumer spending and inflation), increased housing prices, even higher security values, and so on. Although deregulation was less extensive, similar wealth effects were felt in Finland and Sweden's private housing markets.

In Denmark, there were no such effects, only regular business-cycle-related peaks in housing/property prices (1976-9 and 1983-6). Possibly the above mentioned increased financial competition through desegmentation increased the borrowing capacity of households. The increased liquidity position by firms and household together with the lower rate of interest increased the demand for bonds, shares and houses and caused asset prices to rise. But in Denmark, this only lead to a once and for all adjustment of private sector portfolios. Because of previous credit rationing, private wealth had become too illiquid and probably also too high, due to forced savings. As capital market restrictions were lifted, both effects were counterbalanced by heavy borrowing and for a while by a very low saving ratio in the household sector. There was however no vicious circle as in Norway, Sweden and Finland.

Responses

According to Table 1, the response in the late 1980s consisted in a turn to *norm-based policies,* consisting of (a) hard currency policy (leading finally to the ECU-peg); (b) tight fiscal policies to dampen inflation; (c) a low inflation priority; (d) a ban on public borrowing to finance public budget deficits, (e) external deregulation. Furthermore, the response entailed *allocative efficiency reforms* (marginal taxes, privatization, deregulation of product markets, public sector cuts), and an absence of stabilisation-oriented monetary policies (since the interest rate would now support the exchange rate only).

As already noted, Norway and Denmark faced severe setbacks from 1986, while in Finland and Sweden, the upturn continued with escalating overheating well into the 1991. This also implied, as we shall see, that the Finnish and Swedish responses were more closely linked to the question of EU-membership that what is the case with

[21] Jan Fagerberg, Ådne Cappelen, Lars Mjøset & Rune Skarstein, «The Decline of Social Democratic State Capitalism in Norway», *New Left Review,* 181, May/June 1990, pp. 60-94.

Norway. Because of its dependence on fish-catches, Iceland has its own slump inbetween Norway/Denmark (from 1986), and Finland/Sweden (from 1990).

This diversity of developments in the late 1980s is reflected in the macroeconomic indicators: Norway's current account (and Denmark's somewhat later) turn into surplus, while Finland and Sweden record increasing deficits. Finland, Iceland and Sweden have full employment and tight labour markets, while Denmark and Norway experience increasing unemployment. Finland and Sweden, finally, have high growth rates of real GDP, whereas Denmark, Iceland and Norway have relatively low rates.

Denmark had maintained a hard currency line from even earlier, that is from late 1982. The first to follow Denmark was Iceland, which maintained a fixed exchange rate regime from April 1985 to February 1988 with only small exchange rate adjustments.

In Norway, policy makers embarked on a hard currency line after the May 1986 devaluation. Until 1990, the currency was pegged to a basket reflecting the composition of exports. (A currency basket does not as such prevent a depreciation of the value of the currency, so the effects of such as basket depend on the attitudes of the regulating authorities.)

In Finland, the currency was pegged to a basket from 1987, and even before, Finland had not resorted to devaluations as often as earlier. A main motive was to reduce inflation. In Sweden, the hard currency line emerged gradually as overheating and above-average inflation became manifest. The hard currency policy signalled that the government would no longer resort to devaluation. The Labour government made this adjustment long before the conservative government of 1991 made it their main pride. The final stage in this adjustment follows as these countries — again following Denmark's earlier move — replaces the basket-peg with an ECU-peg.

Emphasising internal pressures, the choice of a fixed exchange rate can be seen as a way to signal an anti-inflationary intention in a situation where (1) neoliberal policies (helped by declining oil prices) had pushed inflation down everywhere (solving some of the regulatory dilemmas), but (2) the Nordic countries — unlike earlier — experienced inflation rates above the OECD-average. The hard currency decision was an attempt to escape a vicious circle in which devaluations and above-average inflation fed each others. The case of Iceland — in an extreme way — highlights the impact of domestic concerns with inflation.

The fixed exchange rate also had an external political dimension through its relationship to the EU project. The fixing of exchange rates was a trend all over Western Europe, being connected to the EU attempt to get a «process of state formation» on the rails. This implied a fixed exchange rate as a preparation for its EMU. However, the choice of a hard currency line took place in 1986-7, at a time when the EUs new integration offensive was just starting. The craze about the internal market and EMU comes later. Thus, in the 1986-9-period, we have a norm-based version of neoliberalism, as distinguished from the later more europeanized version of neoliberalism. When the internal market craze had become a reality, however, it became an additional factor used to defend the hard currency line.

Iceland's brief hard currency episode had started in a year of good catches, but as soon as there was a huge drop in export prices, putting the squeeze on fishery profits, the government was under strong pressure from fisheries interests, and gave up the hard currency line. A new sequence of devaluations started in early 1988.

As for monetary policies, the trend towards a higher interest rate continued. With the coming of a hard currency line, the question concerning the relation between a fixed exchange rate and the interest rate level came up. In retrospect, most commentators agree that through the 1980s, a higher interest rate was inevitable. Internal deregulation — as analysed above — mainly affected arrangements that had been designed to secure a low interest rate.

Pegging the currency in this way, so goes the standard argument, makes the interest rate a dependent variable, a function of the defence of the exchange rate. Thus, earlier policy autonomy — the possibility of adjusting the interest rate to pursue domestic stabilisation — has been lost. It is often said that this is inevitable because of the existence of free capital flows. We have indicated that the hard currency decision came prior to deregulation of capital controls. Thus, such an exchange rate strategy does not necessarily require external deregulation; a government may peg the currency to some external anchor even if capital controls are not fully dismantled.

However, even if *de jure* deregulation came late, the external pressure interpretation can point to an earlier process of *de facto* deregulation. There was a trend towards freer capital flows even before the hard currency decision. The roots of this goes back to changes in the world financial system: the deregulation offensives in the U.S. and the U.K., the explosive growth of Eurocurrency markets, and the new communications revolution, the monetary instability of the early 1970s leading to the breakdown of the Bretton Woods system, which again spurred the spread of financial innovation to hedge against exchange rate changes (thereby possibly adding to exchange rate instability). Together, these factors created what has been dubbed «casino capitalism».

In all the Nordic countries, except for Iceland, local firms got increasingly internationalised. The need for international payments increased, and a drawn out, piecemeal process started: Earlier it was hard for persons and firms to get an allowance to trade in foreign currency markets. Now, the authorities began to grant an increasing number of exceptions from these regulations. It is also reasonable to assume that the authorities made a habit of complying with the wishes of business actors seen as crucial currency earners. Applicants probably experienced that their requests for more and more freedom were granted. Then followed a period through which it was still necessary to apply, but all applications were granted. Then, finally, the specific capital flow was made totally free, first maybe for some kinds of firms. Then again possibly a reversal, but finally a full liberalisation.

At certain points in this process there may also have been conflicts, as large firms began to pursue strategies which made it increasingly difficult to maintain credit and exchange controls. As for Sweden, there was already for a long time de facto absence of capital controls with respect to the transactions between the units of Swedish multinationals. In the 1980s, these companies increasingly relied on their foreign units, i.e. the share of foreign production compared to exports from Sweden increased. The development of foreign financial channels and financial institutions within companies resulted in strong capital mobility between Sweden and other countries even before deregulations. All large firms could affect capital movements by changing the date on which export incomes were taken home, foreign suppliers were payed, etc. Multinationals could also influence the transactions between foreign and domestic units (transfer pricing, etc.). Single financial decisions by multinationals and large wood companies could pressure the SEK.

The weight of these factors probably varied according to the economic structure of each country. As for the Nordic area, this implies that it was at its strongest in Sweden, also quite strong in Finland, but weaker in Norway, Denmark and (especially) Iceland.

Finally, other crucial economic actors, such as the state and the banks affected the process by joining the bandwagon. The reforms were all of the muddling through kind. There was no master plan: besides the wish to grant firms easier access to financing abroad, the authorities found the prospect of simplification attractive, and there was the banks' wish to operate more independently in foreign markets. Most likely, networks between the management of large firms, top civil servants and central bankers were influential, and there may be specific paradigms for understanding socio-economic mechanisms. Thus, in this specific context, these networks and shared understandings may have bolstered a connection between the hard currency line and free capital flows.

The end result was that to a much larger extent than earlier, the Nordic economies were now integrated into an international financial system (daily volumes are much larger counted as a share of the currency reserves) and, consequently, that their exchange rate policy has become more vulnerable for the capital movements conducted by speculators.

More specifically, freeing of capital flows has these aspects:

Freer access to international currency markets. The first elements of such deregulation may be granted to banks, then to firms, later they may be extended to private persons. Dismantling of currency restrictions implies the abolition of any roof on the amount of currency that can be exported. This implies, more generally, free exchange of currencies.

Deregulation of credit controls (including trade in various securities). Residents are allowed to buy assets in other countries (foreign investment), and non-residents are allowed to buy various local assets, including national treasury bonds. This liberalisation may take place in stages, as limits are made more generous, and more and more types of assets are excluded from controls.

The role of state borrowing abroad. If inflation/devaluation expectations exist, then foreign investors will only place their funds in a given country provided they earn a risk premium. There is one way to relieve this upwards pressure on the interest rate. The authorities of the country or its private sector may themselves borrow abroad, agreeing to pay back in a foreign (and more credible) currency. In this way, they will pay lower interest rates (compared to loans in their own currency), but on the other hand, they now have to carry the currency risk themselves. Norway and Sweden has at certain times practiced the state-based version, Denmark probably used the residents-based version a lot. Norway and Sweden, however, now banned this option (but Sweden allowed it again when the SEK began to float downwards in 1992).

In the 1986-90-period, Norway and Denmark moved towards austerity, Iceland switched from expansionary to extremely tight economic policies, while Finland and Sweden did not conduct tight enough economic policies to contain the overheating of their economies.

As already noted, Norway and Denmark both had downturns related to factors that put them apart from the main trends of the world economy. As a consequence of the reverse oil price shock, Norway's current account deficit remained at about 5 percent of GNP 1986-88.

In Norway, the Labour government's «turning operation» involved a 12 percent devaluation (May 1986), followed by a hard currency line (exchange rate policies), tighter fiscal policies (a Keynesian move with respect to the international upturn), tax reform, tight monetary policies, and finally, direct intervention in incomes settlements. Monetary policies, thus, were linked to the defence of the NOK, and this prevented the nominal rate of interest from declining along with inflation. As a consequence, both the real rate of interest and the difference in real interest rates between Norway and other countries increased markedly.

Internal conditions were difficult in Norway. The effects of overheating were still felt, especially the labour market remained quite tight. The devaluation of had been decided close to the peak of the business cycle, so capacity utilization was high, and there were not many resources to pull over into exposed sectors. Inflation in 1986 and 1987 proved much higher than the OECD average. As the effects of the policy changes gradually spread through the economic system, full recession followed by 1988. At that time, the banking crisis also broke loose. (The analysis of the banking crisis, however, is postponed to the next section, since similar crises occurred in Sweden and Finland later).

In Denmark, the crisis was due to internal factors: we have already seen that a grave current account deficit developed in connection with Denmark's mid-1980s overheating. The deficit reached 5 percent/GDP, with external debt at 40 percent in 1986. There was a pressure on the DKK, and the interest rate was very high. Unemployment increased, despite a reduction of working time. Growth was lowered due to a squeeze on the domestic market. The Danish government responded by tight policies, the socalled *potato cure*. Restrictions, especially on mortgage borrowing, were reintroduced. In addition, tax deductibility of interest payments was significantly reduced. The financial bonanza was brought to a halt, simultanously with the emergence of a domestic recession implying falling prices in the housing sector. A tax reform was implemented in 1987. Strictly speaking, therefore, it is only since 1986/7 that we can trace a coherent model of economic policy making in Denmark, although this model includes several routines that had been established alredy after 1982. Besides the tax reform, there was stronger emphasis on structural policies, mainly institutional reform (of the public sector particularly), and micro-allocation politics (industrial policies).

While Denmark had long experienced high unemployment, the Norwegian turn to higher unemployment can be studied as an unforeseen consequence of the austerity cure. Possibly, Labour policy makers held that given the tight labour market, a higher level of unemployment was needed as part of the turning operation. But Labour elites did not expect the turning operation to legitimate layoffs on a broad scale. But unemployment rose from 2 percent (annual average) in 1987, to about 5 perc□ent in 1989 and 1990, the largest jump in postwar Norwegian history. The Labour government was quick to apply active labour market policies, these measures increased more rapidly than in 1982-4. But firms simply abandoned any strategy of labour hoarding, laying off a number of allegedly superflouos workers. In 1988, for the first time since international instability spread in the early 1970s, Norwegian employment started to decline.

Norway's «turning operation» can be compared with Denmark's «potato cure». Both involved a hard currency commitment, tighter fiscal policies, and reform of the personal income tax system. Monetary policies were tight, but in Denmark more market-driven than in Norway. Norway had direct intervention in incomes policies, while in Denmark, there was nothing of that. Danish incomes policies 1987 turned out relatively generous, as the «cure» had already changed the behavior that had generated the consumption boom. In both Norway and Denmark, the welfare state was still defended. In Denmark, there was no deterioration in the welfare state benefits through this period. Following some minor cuts in benefits in 1983/85, there has been little change, except for some minor upgradings.

There was a general world economic upturn through this period: International demand was growing, with favourable effects for traditional Noric export sectors. Oil prices also picked up towards the end of the 1980s, with positive effects on both

Norway and Denmark. Norway's external balance improved to roughly balance in 1989. Thus the government embarked on more expansionary fiscal policies in late 1989, trying to halt the growth of unemployment.

Also in Denmark, there was a relation to oil production. Danish oil and gas production gained pace in the mid-1980s, just when prices started to slump. Still, by the early 1990s, Denmark had become 90 percent self-sufficient in energy. The current account deficit withered away. Conditions in the domestic market (construction and private consumption) — the market which has traditionally been the growth engine of the Danish economy — improved a lot. Thus, there was less restraint on fiscal policies in the early 1990s.

In Finland, the situation remained idyllic. Following the revaluation of FIM in March 1989, Finland surpassed Norway and Sweden in terms of income per capita! But problems were now accumulating. Overheating was indicated by the household propensity to save, which went down to 1-3 percent for the years 1988-89. The current account deficit was about 5 percent of GDP in years 1989-1991, as a legacy of overheating. Perhaps the most telling indictor is the annual growth in the banks' loans (nominal) portfolio, which was 30 percent in 1988 alone — a token of financial overheating and the credit-driven bubble. Having escaped economic instability since the late 1970s, Finland was ripe for a most severe disappointment.

As noted, Sweden's Third Way policy basically amounted to the 1982 devaluation and the 1982-5 incomes policy. Too loose fiscal policies, and deregulation of credit markets in a situation with an unreformed tax system, are the most important factors behind the problems created by the Third Way approach. These factors explain the lack of renewal and productivity growth in Sweden's established manufacturing firms in the 1980s. After this attempt to stay unique, interventionist policies were given up, and the economic policy priorities of the Swedish model were changed. The view that competitiveness could be raised by devaluation was scrapped. It was feared that international capital markets would loose all confidence in the SEK (with higher interest rates as a consequence), while labour market agents would expect further devaluations, internalising this expectation in their wage claims. Any kind of expansive economic policy was ruled out. Some economists even started to attack the last element of interventionism: labour market policies were seen as inflationary (at least its demand components) just like any other expansionary policy. The main arguments refered to international capital markets, and the consolidation of inflation expectation among labour market partners.

Deregulations and cuts in taxes on work and profits together with cuts in public transfers were the most striking characteristics of the new policy. Furthermore, norm-based exchange rate policies were gradually introduced, starting 1985-6. In fiscal policies, there were countercyclical ambitions about avoiding overheating.

This policy turn lead to more serious tensions than ever between Labour and LO in this period. After a while, LO could see redistributive effects, such as the stock market booms, wage drift for white collar workers, social expenditure cuts, etc. As an alternative, LO economists supported a strategy of continuous devaluations (continued Third Way routines), strengthening competitiveness at full employment. They felt the pressure from grass-roots criticism of Labour's economic policies (e.g. the Dala riot). The party expected LO to accept a restrictive fiscal policy and wage-moderation to avoid overheating. Thus, LO ambivalently switched back and forth between furious attacks on the government and declarations of loyalty.

Sweden had strong overheating both in 1989 and 1990. At the peak — the first half of 1990 — the Swedish Labour government began to worry about rising wage costs, loss of market shares, high inflation (wage/price spiral, high rates of capacity utilisation) and an interest rate differential indicating expectations of yet another Swedish devaluation. The Labour/LO «war of the roses» culminated as the government tried to cool down the economy by restrictive fiscal policy. In February 1990, a government incomes policy proposal to freeze prices and wages, also implied a ban on strikes. Suggested fiscal measures were: VAT increases, some reductions in social security measures (e.g., no pay for the first two days of sickness), reduction in transfers to families. The incomes policy measures were a threat to low-paid workers in the public sector, who had not yet reached a wage agreement. Still, the proposal was initially sanctioned by the LO leadership, but strongly opposed by the Municipal Workers' Union and by local units in other trade unions. A political crisis led to the retirement of the main architect behind the Third Way — Finance Minister Feldt — and to the formation of a new Labour government (Carlsson II), which presended a modified (no ban on strikes) package against overheating. Swedish poll data shows a strong decrease of support for Labour between the late 1980s and spring 1991, reflecting popular rejection of the marginal tax reforms, public sector cuts and restrictive fiscal policy.

The Swedish response indicate two important changes: First, reductions in the welfare system was now a legitimate policy strategy, even for Labour. Second, the crisis demonstrated the much weaker position of LO, which was squeezed between the government's demands for a responsible incomes policy, and the need to represent its members. Even in core LO unions, members now protested.

Besides incomes policies, tax reliefs were used to raise Swedish competitiveness. Nominal profit taxes were scaled down from 52 to 30 percent (the general tax level), clearly below the OECD average. This move was justified with reference to efficiency and fairness. Possibilities of making tax allowances were restricted, partly to avoid locking-in effects. There was also other structural reforms, such as deregulations in agriculture and in the service sector (including local government). When the deregulations of the 1980s are added, it is clear that Sweden had made a system shift which the non-socialist parties reluctantly had to admire. But even pegging to a basket was not enough, as we shall see, the SEK would soon become pegged to the ECU. This put tough limits on incomes policies.

Not only Sweden and Finland, but also Iceland, experienced an upturn since 1986. In 1985, it had become generally accepted that devaluations had created major difficulties for the fisheries sector, given its indebtedness and the new (high real interest rate) environment of the 1980s. But in 1986 and 1987, fisheries exports boomed, due to favourable terms of trade trends. There were concessisons designed to facilitate a transition to the hard currency line (1986-88) mentioned above. Relaxed controls on private foreign borrowing led to yet another boom in foreign borrowing. The long term foreign debt was in 1986 around 45 percent of GDP, exceeding total export revenues by almost 18 percent. The government clung to its hard currency policy, but a minor fall in export prices produced strong claims for a corresponding devaluation of the ISK. Naturally, the government lost the mid-1987 election. The new government, however, embarked on an even firmer neoliberal line, but had to allow devaluations in February and May 1988. The provisory law of May 1988 made for extremely tight incomes policies. By 1988-9, the conclusion for Iceland was: a failure to implement a hard currency policy, new monetary disorder (credit boom), and very little external deregulation.

A National Reconciliation agreement (1989) involved small wage increases, reductions in nominal interest rates, and large reductions in agricultural prices. Behind it was a new plan of reorienting Iceland's exchange rate policy. The programme brought down the inflation rate from the two-digit level to around 7 percent in 1990, producing a negative real wage development in 1989.

Fiscal deficits remained large, and the debt burden became increasingly difficult given the low growth rates of the early 1990s. This demonstrates the problems involved in economic policies which try to use exchange rate adjustments as growth stimuli. Such a policy, namely, creates the need for even stronger fiscal adjustments.

Furthermore, there were warning signals on the fishery stocks. In early 1988, the government believed that only a traditional short term slack in catches was coming. Still, restrictive economic policies were adopted with a view to long term stabilisation. Catches, however, did not recover. However, the creeping ecological crisis relating to Iceland's fish resources cannot be discussed further here.

Third disappointment — early 1990s

We have seen that market-oriented economic policy strategies were transformed from the early 1980s constellation of devaluation (floating) plus internal financial deregulation to the late 1980s constellation of a hard currency plus external financial deregulation. To some extent, this implied that the other countries followed Denmark.

In the course of the 1980s, instruments that maintained full employment had given rise to very high inflation. *National neoliberalism* had stimulated (in a rather Keynesian way) the economy via devaluations. To all except Denmark, full employment had been no problem in the 1980s. In these countries, the long 1980s upturn had even started from a situation of full employment. Now, there was more of a stop/go-situation: first fight inflation, then return to the task of securing full employment.

Generalized experiences

According to Table 1, the following problems remained: (i) high relative inflation (except for Denmark), mainly in the early part of the period; (ii) relatively low production growth; (iii) current account deficits (except in Norway, Denmark improving); (iv) higher unemployment, first in Denmark and Norway.

But the main component of this third disappointment was that the implementation of norm-based policies did not stabilise the economies. Norm-based exchange rate and monetary policies, coupled with allocative efficiency reforms could not hinder the outburst of an economic crisis. In fact, what followed was a crisis of unprecedented magnitude (at least in Finland and Sweden), and marked by an entirely new feature, namely the interaction between a real and a financial crisis (with Denmark and Iceland as partial exceptions, for reasons that we shall state below). This interaction between real and financial crises was crucial to the disappointments of the early 1980s.

Both the real and the banking crises were the worst in the whole OECD-area. The boom in finance and production was per se an important reason why the subsequent crisis per se became so deep, since the bursting of a financial bubble can worsen a real economic crisis.

The interaction between tight economic policies and financial deregulation (external and internal) contained an internal contradiction in as much as the instabilities that followed could only be mastered by strongly interventionist policies. But such intervention was politically hampered by the fact that norm-based neoliberalism —

having grown into a political culture — preached that interventions had to be avoided.[22] As a substitute for such interventions, the exchange rate was made into an anchor.

A main policy failure in the late 1980s was that Swedish and Finnish authorities managed the money market in a way which was not consistent with the capacities of the political system. The general public did not know how to behave in such a deregulated situation. Alternative options were displaced: Swedish and Finnish banks should have required higher reserve requirements, earlier tax reforms, higher interest rates.

Now, we have seen that Norway and Denmark had in fact taken measures to contain their early crises, so the problem of non-interventionism was most marked in Finland and Sweden. To some extent the norm-based approach to economic policies implied neglect of intervention to counter overheating and asset inflation in the late 1980s in these countries. Sweden's fiscal stance remained expansive through to 1989, producing a booming economy, helping Labour to win the 1988 elections. On the other hand, some necessary changes in tax legislation were made, and from 1989/90, there was a tightening of fiscal policies.

An interesting discussion can be raised about the emergence of a neoliberal approach in Finland. According to our earlier analysis, the absence of both the first and the second disappointment should imply that conditions were not good in Finland for neither the national nor the norm-based version of neoliberalism, and we have in fact earlier argued that neoliberalism was absent in Finland. We shall argue that neoliberalism did not emerge as a *political* initiative in Finland. One should remember that in the late 1980s the Soviet Union was still there, and in Finland it would have been more difficult than elsewhere to make neoliberalism an open political banner. Rather than a political movement, therefore, a sort of technocratic neoliberalism evolved in Finland, as the relevant ideas were gradually absorbed by policymakers, civil servants and central bank officials. Thus, in Finland, norm-based neoliberalism arrived as a political culture only after the end of the Cold War, and this happened to coincide with the massive economic crisis. Thus, the role of neoliberalism as a constraint on economic policy action was perhaps most exposed in the Finnish case.

Finland was similar to Norway and Sweden in terms of financial structure and crisis. Thus, as we noted, through the 1980s, the Finnish model had become more Nordic, and we shll now see that it was hit by problems quite similar to the two arch-typic Nordic countries. Finland's fate was thus to «become Nordic» at a late stage, being very quickly exposed to the inherent contradictions that had been accumulating. Finland became Nordic just in time to take part in the crisis.

Denmark was the pioneer in norm-based policies, having already earlier switched to a hard currency policy. But the changes caused by more market-oriented policies were more extensive in the other Nordic countries. Thus, in the comparative discussion of the third disappointment below, we shall see that Denmark after a relatively mild crisis in the 1986-8-period in fact turned out to have less of a financial crisis than the others.

The financial crisis can be seen as the end of a sequence that started in the 1980s: deregulation — consumption boom — asset inflation (loan-financed booms in the stock and real estate markets) — followed by general recession (with especially the property market falling), and a consequent banking crisis.

[22] Neoliberal influence denied that the political system had any problem-solving capacity at all. Policy makers had erroneous expectations as to the size of future production capacity. The end result was cuts and setbacks in the welfare state which would not have been necessary if these countries had not made these economic policy failures.

The financial sector may live its own life via reflated stock-/bond-prices, contagious towards the property market. This is an autonomous dynamic, but it is more easily released in periods of real-economic optimism. The state interventionist financial systems of the Nordic countries (except Denmark) had earlier barred such autonomous financial developments. But internal deregulation introduced a structure which allowed such financial instability. We have already shown that there was such an asset inflation process going on, nourished by the mid- and late-80s boom. In a situation with overexpanded balances, the cash flow must be maintained, else the bubble bursts.[23]

The situation was perhaps more unstable than in the normal case in which a country (e.g. the U.S.) has experienced financial instability for a longer spell of time. In the three case countries, the structure of the regulation system was changed. The following asset inflation process was unique in their postwar histories. All the routines of the financial sector related to the earlier system with rationing. A generation of managing directors were used to borrow whatever they could. In the deregulated situation, the result was bound to be bad banking, bad management, bad risk-evaluation. Interest rate risk was a wholly new concept.

Deregulation unleashed repressed demand for loans. The banks, free from the tutelage of the central bank and unaccustomed to operating in a market-oriented environment, increased their loans in a rather cavalier way and generated a boom of speculation and investments of dubious long-run quality. (This feature seems common to all the cases. Iceland is an exception, but only in the sense that Iceland already had experienced a series of credit explosions. Both consumption and investment booms are more common in Iceland.) The central bank failed to curb the banks' loan expansion and to impose effective controls on the soundness of bank lending. Banks competed aggressively for market shares and were ready to accept dubious collaterals and to finance almost entirely leveraged speculative investments. The central bank neglected the need to control the banks' activities, and nobody seemed to be in charge of the aggregate outcome. Banking interests were well represented within various public bodies responsible for financial supervision, and the supervising authorities did not enjoy sufficiently wide discretionary powers to stay well informed about the loan expansion, let alone to enforce effective sanctions on them. The government did not appreciate vigorous fiscal stabilisation.

The inflated assets could only be reproduced if there was a constant cash flow. As overheating turned into crisis, the bubble of inflated asset prices burst, and the tightening of economic policies in the crisis started off a vicious circle. General deflation would secure that competitiveness was maintained in the period after overheating. Deflation implied an attempt to reduce all nominal prices (but wages in particular), so that the price level would be reduced compared to the main competitors in the OECD (Western Europe in particular). The aim was to increase the competitiveness of exports. This is always difficult. But in this specific historical situation, firms and households had very high nominal debts, and it was virtually impossible to adjust such a debt burden downwards. This is the problem of debt deflation, for instance: if a person is highly indebted through a mortgage loan, this debt will not be reduced even if her wage is halved by deflation. The situation was made even worse by the hard currency commitment, which by keeping the interest rate very high, increased the pressure on firms and households that were already in a debt-trap situation.

[23] Hyman Minsky, *Stabilizing an unstable economy,* New Haven 1983.

As for the crisis of the real economy, internal and external deregulation had resulted in huge increases in interest rates, which butchered large parts of Nordic businesses, spurring unemployment. This was above all so in Finland and Sweden. But the general background in overheating and asset inflation is similar, despite the different timing of the crisis in each case country. Overheating and asset inflation was a new feature compared with the Golden Age, which had implied structurally low interest rates over cycles and cyclical fluctuations in exchange rates.[24]

Comparative record

We have seen that Norway and Denmark experienced a late 1980s downturn, while Finland and Sweden followed the general Western European boom. The financial crises were similar with the real economic crisis in Finland, Norway, and Sweden. Norway's real economic crisis, as showed above, came earlier, and Norwegian authorities had done a fair amount of adjustment when the trouble started in the banking sector (1988). In the cases of Finland and Sweden, the overlap and interaction between the two crises were more complete.

In Denmark and Iceland, although we can trace elements of financial instability, there were no severe banking crises. In Denmark, internal and external deregulation had started earlier, and a coherent model had been established (since 1987). Iceland, finally, seems to have much more experience with dramatic adjustments, but the turn to a hard currency approach — not complete until the 1990s — implied potential dangers.

From the autumn of 1990 (roughly simultaneous with the outbreak of the Gulf war), the international economy turned to a recession. At this time, for other reasons, the disintegration of the former Soviet economy became cumulative. Sweden was mainly hit by the first factor, Finland by both. In late 1990, policy makers in Sweden and Finland became aware of these problems. In a short time, the Finnish and Swedish economies moved between two extremes, from overheating to a deep recession. Although the crisis was milder in Sweden than in Finland, it was still much worse than elsewhere in the OECD area. For Finland this was the most severe economic crisis in the 20th century, for Sweden, the most severe since the 1930s. Attempts to tighten policies first got into great difficulties since there was still full employment and plenty of labour market bottlenecks. In Sweden, this lead to several smaller crises for the social democratic government, which in the end lost the 1991 elections.

In the following, we provide a generalisation on the interaction between the real and financial crises for all the three countries, Finland, Norway and Sweden. There is a slight difference in timing, as the Norwegian crisis developed earlier (from 1988) than the Swedish and Finnish ones (from 1991).

The difficult economic situation weakened the banks. High interest rates interacted with lower asset prices (the bubble bursting) and increasing credit losses. Let us start by considering consumer behavior. Declining real incomes, an increasing real rate of interest, and the simultaneous tax-reform forced many households to use a much larger proportion of real income than earlier to service debts. Even later, when the banks recovered from years of dramatic losses, they tended to be slow in passing reductions in the central bank interest rate on to the public. The governments tried to compensate by

[24] Note that *de facto* high interest rates in real, post-tax terms were achieved much later than when a higher interest rate was first launched as a policy goal! The interst rate shock reflected deregulation and the fact that policymakers wanted to get rid of the inflation-devaluation legacy. See also Hans T:son Söderström, «Ränteshocken och skuldkrisen», *Ekonomisk Debatt,* 1995:3.

various targeted credit relief schemes, but the impact of such schemes were not large. Most households decided to decrease their level of indebtedness, or at least not increase it. As a consequence, households were unwilling to make new investments in housing. Demand for housing declined, and so did prices. This reduced the wealth of households, leaving them even more exposed than before, widening the recession.

This brings us to the behavior of business firms: the recession, together with other profit-depressing factors in the business sector, weakened demand for commercial facilities which particularly hit real-estate and construction. Repayment difficulties and outright bankrupcies affected banks directly and also led to reduced demand and prices of business property. Banks had to accept increased losses or were forced to take over low-price real estate items. Banks were forced to tighten conditions even for firms who were possibly able to survive the business cycle downturn (to some extent this was the case also in Norway).

In the end, the losses were carried over to the banks. Safety fund accumulated by the banks (or their peak organizations), ran out quickly when problems aggravated. In addition, the demand slump increased problems for firms with a high debt-equity ratio. SMEs were hit by credit restrictions and interest rate increases. This also contributed to the stock market and real estate slumps. Even in Norway, in a situation in which a real recovery had begun, this mechanism can be traced.

In Norway, the government's wish to adjust towards EC-standards further worsened the financial crisis. In March 1991, Norwegian authorities responded to international influences by adopting new requirements for capital adequacy.[25] Striving to meet these requirements in a situation of general financial crisis, banks were forced to slim their balances. They did this by getting rid of customers, maintaining a very high interest rate, that is, with a large margin between various funding costs and the interest rate charged from customers.

All the most important banks were now loosing their equity capital, bringing the whole financial sector on the verge of collapse. Facing the danger of a complete breakdown of payments and credits, the governments had no choice but to rescue the banks by means of large cash-injections. Finland had the most serious banking crisis in the Nordic area. Total support to banks as a consequence of the crisis, was about 65 bio [mia] SEK in Sweden, and ca. 65 bio [mia] FIM in Finland. This implies that the Finnish crisis was graver, as the FIM exchange rate is higher than that of SEK, and the Finnish GDP lower than Sweden's. Norway, by 1993, the state had spent the amasing amount of 20 bio NOK to stabilise the banking system (3 percent of GDP). [Better data to be included later!]

[25] During the earlier credit policy regime, primary and secondary reserve requirements were main instruments in the Keynesian «technocratic» attempts at macroeconomic fine tuning of total lending by financial institutions, as noted above. Such reserve requirements implied that a certain amount of total assets should be kept as cash or in other very liquid forms. Capital adequacy requirements, in contrast, requires that the capital base is a certain share of total assets. Such a requirement primarily intends to ensure the prudence of single financial institutions. It is not to be used as a policy variable, but as a «constitutional» provision to ensure stability and predictability, and thus suits a liberalised credit policy regime. The Bank of International Settlements in July 1988 recommended international harmonisation of capital adequacy requirements (8 per cent). This requirement was adopted by the EC in a December 1989 directive. The Norwegian Ministry of Finance released similar directives in March 1991, with a first deadline towards fulfillment of the 8 per cent requirement by December 1991. Cf. *Bankkrisen,* NOU 1992:30, p. 23 f. This policy was thus an expression of international pressure, but mediated through the wish to harmonise with EC developments.

The result was more extensive state involvement in the economy than ever before.[26] Through their rescue of the banks, the state determined the size of the banks' capital base, thus also defining an upper limit to their lending. The Ministers of Finance — caught in an unsolvable dilemma — kept urging the banks to lower interest rates, while this could only happen if the state granted them even more support, which was obviously impossible. The interest rate level was kept high. In Norway, this was particularly paradox, since the country now experienced an external surplus, while unemployment remained high. The fact that Bundesbank compensated for Kohl's expensive policy of reunification, lifting the interest rates high all over Western Europe was also partly responsible.

Why was Finland more hurt than Sweden? Three factors seem important: First, the disappearance of trade with the east. Second, restrictive fiscal policies. In contrast, Sweden had expansive fiscal policy 1992-93, although it was not planned that way. Finland's banking crisis influenced lending to firms to a larger extent than in Sweden.

Finally, let us consider the two contrast cases, Denmark and Iceland. In Iceland, there were elements of a crisis: Certain state funds reported losses in 1992. These credits had been given out for the purpose of restructuring agriculture and developing fish farming. Many firms and farms were on the verge of bankruptcy. Still, the government did not proceed to close down any of the big funds, but had them reorganised. Why was the Icelandic financial crisis not as devastating as the crises in Norway, Sweden and Finland? Trends such as growth impulses, credit explosion, and hyper-increases in real estate prices, were there. As we saw, there had been some internal deregulation. There was also strong downward price pressures (stronger than in the other cases). But there were important differences. First, credits were still channeled mainly through loan institutions. The banks only control about 25 percent of credits. The House Mortgage System took care of most of the volatile housing credits. Second, Icelandic banks seems to have had a policy of writing down lost credits all along the line instead of keeping hopes. In 1985, they wrote of 1.07 percent, and in 1990 1.26 percent, while e.g. Swedish banks only wrote off 0.24 percent and 0.71 percent.[27] In 1991 alone, an average Norwegian bank wrote off 3.36 percent, and an average Swedish bank 2.22 percent of assets, while the Icelandic banks only needed to write off 1.12 percent. Third, reserve requirements in Iceland were kept high, ten times higher than in Sweden, following the deregulation of interest rates. This was done despite protests from the banks, but it may after all have stabilised their economic situation. Fourth, Iceland was still behind the other Nordic countries as regards external deregulation, there is still no free flow of short-term capital. This may have saved Iceland from losses in connection with the international crises. Many Nordic firms and banks made grotesque losses in overseas transactions, possibly due to increased risks in affairs involving foreign agents and markets. Considering the experiences of the other Nordic

[26] In Finland, trouble for the banks started in the fall of 1991. Even larger banks followed in 1992, and by 1993, almost all major banks were bankrupt in real terms. Despite huge state support, the banks thus maintained a very strong position in the corporatist framework: The state committed itself to the rescue of all banks, public money were used not just to insure depositors, but also to prevent banks' shareholders investment from melting away. The support scheme that was adopted may even create perverse incentives for banks, their debtors and their depositors to collude at the expsense of the taxpayer. In contrast, the Norwegian government was somewhat harsher: The shareholders of the two largest investment banks actually lost their investment.

[27] R. Haflidason, «Bankakreppa i Noregi, Sviithjod og Finnlandi — samanburdur vid throun mala a Islandi» [The Bank crises in Norway, Sweden and Finland — comparison to development in Iceland], Central Bank of Iceland, *Fjarmalatidini,* No. 1, 1993, p. 63-4.

countries, one may wonder if further deregulation and privatisation of the financial sector was a wise move.

Denmark had even less of a banking crisis in this period. Also in Denmark, there was an experience of asset inflation. Denmark's bubble in the housing market burst 1987-88 (fairly simultaneous with Norway), and together with developments in the labour market, and the January 1987 tax reform, this marked completion of the potato cure. As noted earlier, there was instability for certain institutions (mortgage and insurance). De-segmentation of financial markets spurred increased competition, and led to overstretching on the part of certain financial institutions, as they tried to extend their activities by buying (expensively) into new fields. These problems seems to have peaked in 1989-91. But there were no major troubles in the banking sector. In Denmark, the financial failures were more spread over time than in Finland, Norway, and Sweden, and the capital base was somewhat higher. Thus banks were able to avoid direct government intervention through the period. Denmark had also had an earlier burst, as bond and property values had already slumped in the early 1980. Denmark also had higher reserve-requirements. Rationing was never as strong as in the other countries.

Denmark's financial crisis was less severe than in the other countries, and it also had a more narrow range of causes than in the other countries. The crisis was mild above all because the system being deregulated was very different from the financial systems of Finland, Norway and Sweden. In the case of Iceland, the original system was quite similar to these countries, but deregulation had not at all proceeded as far as in the other cases.

Concerning the financial crashes, the comparative analysis shows that there were alternatives. Financial crisis was not an inevitable fate for any Nordic country. The cae of Iceland is particularly telling. Here the original financial system was organized in much the same way as in Finland, Norway and Sweden, and since deregulation had not proceeded as far, the crisis was avoided. As for Denmark: the main feature was a different point of departure, a different kind of organisation of the financial system.

Responses

We have seen that in 1989, the Norwegian economy was just past the bottom of a severe economic crisis, while the Swedish and Finnish economies were in a state of overheating. Iceland and Denmark, like Norway experienced crisis in the last years of the 1980s. Denmark was barely recognising trends towards a recovery, while in Iceland the crisis continued. In this situation, the EU single market programme emerged as a success. The impact of this new Western European integration offensive on the Nordic countries differed, as Denmark was an EU-member, while the four others were outside. Denmark thus followed the implementation of the Single European Act directly, and was also hooked on to the EMU/Maastricht-treaty-process. Also influenced by the recent demise of the Cold War security structure, the others now begun to approach the EU. All the EFTA-countries engaged in negotiations to establish the EEA, the European Economic Area (which would give them «membership» in the single market, but non-membership in the political union). But the Nordic non-EU members also proceeded to apply for membership.

In connection with the crisis package — against overheating — in the spring of 1990 (which lead to the resignation of the Carlsson I government), Sweden's Labour government announced that Sweden would apply for membership in the EU. This could be interpreted as a move to calm down capital markets, thereby possibly also reducing the domestic interest rate. In October 1990, this new attitude towards EU-membership was confirmed, and a membership application was presented in the summer of 1991 even before the Maastricht-treaty had been signed in December 1991. Still, that treaty put additional requirements on Sweden.

Somewhat later, in March 1992, at the low point of the economic crisis, Finland applied for EU-membership. The decision related to the economic problems, and also the weakening of Soviet communism in the East. Finland's position between the leading communist and the leading social democratic countries influenced its ideological climate in many ways. When the Soviet experiment lost its attraction and the Swedish third way was in a deadlock (also to be solved by EU-membership), Finland too would look westwards, to the EU.

Unlike these two countries, Norway had applied for membership in 1972, only to experience fame as the first — and so far only — applicant country in which membership was voted down in a referendum. Since then, the question of Norway's relationship to the EU had been exiled from Norwegian politics. With the start of the EEA-process, this question soon rose to the top of the political agenda again. The preparation of a new application took longer time than in the neighbouring countries. The non-socialist coalition government (of late 1989) broke down due to disagreement on the EC-question in 1990. Only after extensive discussions within the ruling Labour party 1990-92, the application was presented in December 1992.

Iceland declined to negotiate for membership. Only the rather small Labour Party was in favour of memberhsip, while both the Conservatives, Agrarians, and Left Socialists were against. The main point was of course the expectation that the EU would not allow Iceland full control over the fisheries resources.

There were of course elements of genuine political will among the political groups that favoured of EU-membership. But in Sweden and Finland, there was also the wish that integration would spell a way out of the difficult economic problems. This was not just a question of the single European market, since already the EEA-agreement implied extensive access to that market for most firms. Since negotiations would be finished after the ratification of the Maastricht-treaty, the applicants had to accept its scheme for an EMU (Economic and Monetary Union), a scheme which implied a considerable sacrifice of economic policy autonomy.

However, such a sacrifice would only serve to bolster the line the three countries had already embarked on. While they had adjusted to the challenges since 1973 with considerable success, the crises of the early 1990s was sson as a proof of a dramatic reduction of their economic policy autonomy. Following the mid-1980s disappointments, the policy of competitiveness had been rephrased as a norm-bound policy, with the ECU as the external anchor. Membership in the EU would formalise this situation, and as members, the countries would have a say in the EU-institutions. Anticipation of a closer association with the EU (either through the EEA or full membership) were used as arguments for further deregulations.

Denmark was a special case, already being a member. As a member, Denmark proved hesitant with respect to the new offensive for integration. In the first Maastricht-referendum of June 1992, Denmark voted against the treaty, threatening the whole treaty which required consent by all signatories. In this situation, Labour and the Radical Liberals discussed with the Left Socialists (Socialist Peoples's party), producing a socalled national compromise. At the EU summit in Edinburgh (December 1992), this compromise was accepted in the form of a unilateral Danish declaration. This declaration excepted Denmark (1) from the third phase of the EMU, i.e. common European currency, (2) from the common European defence policy, (3) from the rules for European citizenship, and (4) from participation in internal police and justice cooperation (the third pillar). It was accepted by a majority in the new Danish referendum of 1993.

It was noted, ironically, that after the accession of Finland and Sweden from 1995 (see conclusion below), these two new Nordic entrants now had stricter terms of membership than the older member, Denmark. (As for the setbacks in EU's move towards an EMU, we provide some brief comments in our conclusion.)

We shall now turn to economic policies, focusing particularly on efforts to counter the crisis.

Norway could record relative success. The two main reasons for Norway's relative success were linked to state activity: first, since 1989, the government embarked on very expansive fiscal policies (Table). Second, there was a boom in the oil sector, due to a general price increase in connection with the Gulf-war (ending in March 1991), increased production, cost-cuts due to new technologies and increasing investments in this sector. Norway and Denmark were both blessed by increasing oil prices, but the Norwegian economy picked up earlier, due to more expansive policies. Norway recorded the highest GDP growth rates in the area in the early 1990s, but even there, the recovery came as late as 1992. Having adjusted early, Norway's and Denmark's economic development in the 1990-93-period was better than that of Finland and Sweden.

In both Sweden and Finland, the governments had to tackle their worst recessions in decades in a situation in which interventionism (except for labour market policies) was ruled out. In 1991-2, the *norm-based policy approach* reigned.

In Sweden, the government put its faith in structural reforms (europeanisation, profit-tax reductions) to affect investments and growth positively. Like earlier, there was no active growth policy, except for infrastructural investments in telecommunications and transport. Sweden used one instrument more actively than the Finns: Labour market policies survived under the non-socialist Swedish government. This is one important reason why the Swedish unemployment rate did not rise as dramatically as the Finnish one. Young people were given temporal jobs to get vocational training, while relief works were scale down somewhat.

In Finland, the policy response to the crisis — involving a debt burden of 40 to 50 percent of GDP — was a mix of old routines and policy innovations. There was much uncertainty about economic policy strategies. We have noted the procyclical tradition in Finnish fiscal policy and the emergence of stabilisation-orientation since the late 1970s. With the dramatic crisis of the early 1990s, elements of the old cameralist model of economic policy returned, with devaluation and procyclical policies. Finnish decision makers were genuinely confused. For ideological reasons they were against the 1980s corporatism. But the strategy of deflating wages while the economy is in a debt trap, is an impossible one. Thus, it was impossible to fully discard the 1980s corporatism. The government's goal of keeping inflation low required corporatist incomes policies. The functional needs contradicted the ideological convictions. Finland was the first Nordic country in which the ECU-preg broke down.

For instance, the devaluation November 14, 1991, spelled trouble for incomes policy negotations, indicating that the vicious circle of devaluation and compensation claims — so typical of the Finnish model in its earlier days — had returned. At the very least, the demands on incomes policies to keep down inflationary wage demands, and even to achieve general nominal wage cuts during depressions, had become very heavy.

Finland's main economic policy effort was to boost exports. Fiscal austerity led to decreased demand 1993-6. Economic restructuring was uneven: exports grew by 9 percent in 1992, and this rate is expected to continue thanks to good competitiveness. At the same time, the sheltered sector of the economy is plummeting. Consumer demand was shrinking well into 1995 [?]. This reminds of the old model: exports are boosted, domestic demand depressed, and public expenditure is cut. There has been no commitment whatsoever to keep up economic activity in the domestic sectors. Export growth did not reduce unemployment from its March 1993 level of 17 percent.

In Sweden, the non-socialist, minority government came into office from Fall 1991. Bildt's government implemented an even stronger version of the norm-based policy, dubbed «The only way», in contrast to Labour's «Third way», thereby obscuring the fact that already Labour had switched to a norm-based policy. The non-socialist Only Way had these components: (1) Fiscal policies would be kept so tight that voluntary incomes policies (cf. Rehnberg commission) would be unnecessary. (2) Even stronger priority to the struggle against inflation, despite accellerating unemployment and a strong reduction of the pace of inflation. (3) The planned EU-membership would be a more binding constraint on economic policy. The convergence-criteria of the Maastricht treaty — including the strong emphasis on price stability — were used to legitimate policies. VAT-reductions in 1992 aimed at harmonisation with EC-levels. Pegging of SEK to ECU had been done before the election by Labour (on May 17, 1991). (4) Norm-based policy would also, it was argued, benefit productivity growth by exerting transformation pressure. The Ministy of Finance, for instance, rejected lower pay-roll taxes to increase the competitiveness of Swedish firms. Norm-based policy promised reduced nominal wage growth, higher unemployment, high productivity growth in Swedish plants, and the marginal tax reform.[28]

As for the position of the labour market partners, SAF felt strong and planned (early 1990s) to refrain from participation in all the corporatist institutions of the Swedish model. Only LO stood to gain if SAF remained in all these public and semi-public arrangements. SAF would rather act as a major political lobbyist. This more sharpened ideological climate implied fiercer attacks on the institutions of the Swedish model.

LO was the only main actor which opposed the norm-based policy, advocating a flexible exchange rate and opposing reductions in public transfers, even under the Labour government. But LO also supported the policy of increasing long-run profit shares and profitablity, especially in the exposed sector, and remained uninterested in industrial policies (e.g. towards SMEs). This contributed to the weakening of LO. In contrast to the LO, the Metal Workers Union had been engaged in industrial policy matters during the 1990s, and also pleaded for a policy oriented towards SMEs. The Bildt government used money from the phased-out wage-earner funds (introduced by Labour in 1983) for basic research and to supply small and medium-sized companies with venture capital.

There was a marked fall in Sweden's relative rate of inflation in 1992, but also an increase in relative unemployment. Productivity growth in industry increased, largely

[28] In contrast to Finnish exporters in the forest sector, Swedish raw materials industries were not actively working to support the change to flexible exchange rates. The reason may be that the raw materials producers have a stronger position in Finland than in Sweden. Another possible reason is that the transformation pressure argument did influence crucial decision makers in Sweden in the early 1990s. If decision makers in the raw materials industries were convinced that politicians would not give them a new breathing-space by yet another devaluation, they felt forced to raise cost competitiveness through productivity increases. (Rationalisation, lay-offs, less labour hoarding, technical change.) Swedish multinationals benefitted less from devaluations and supported the Only Way due to its overall profile.

due to extensive rationalisation.[29] After a long period of lagging behind the OECD countries, industrial productivity growth in Sweden overtook growth in most of the other OECD-countries in 1992-3. Competitiveness in terms of relative wage costs and company taxation was satisfactory towards the end of 1992, which was also noted by foreign investors and multinationals. However, the policy of the *Only way* failed in its main task, that is: to create confidence in the SEK. The November 1992 currency crisis ended in the breakdown of the hard currency strategy.

As for the situation after the breakdown of the hard currency part of the norm-based policy, the Bank of Sweden avoided a major British-style cut in the bank rate (counter-cyclical monetary policy) when floating was introduced and the SEK started to fall. The Swedish government feared that nominal long-term interest rates would stabilise above the international average, thus squeezing investments and pushing the SEK further down. The interest rate should be brought down gradually in train with the Bundesbank rate, to counter any expectations of devaluation. The hard currency norm was replaced by the monetary policy norm that inflation (and thus a free fall of the SEK) should be avoided. Only in 1993 disposable household incomes decreased. Depreciation of SEK worked in an expansive way. But employment effects were small due to uncertainty and rationalisations. New signs of recovery favoured raw materials industries, with few employment effects.

There had been some elements of the old Rehn/Meidner model in the Only Way.[30] With the «savings packages» and the turn to a floating exchange rate, these elements were lost. Reduced payroll taxes implied a general subsidy to profits. Floating rates reduced the chances of exposing the companies to transformation pressure. In one year the SEK depreciated by 25 percent against the currencies of the trading partners, a reduction as huge as the two devaluations in the early 1980s taken together. In addition, the government proposed in the autumn of 1993 a further reduction in taxation on capital and profits. More in line with the Rehn-Meidner norms, fiscal policy was relatively cautious, despite a deep recession.[31] Monetary policy was cautiously expansive. Labour market policies were still ambitious, with no such policy, open unemployment could well have been 13 rather than 9 percent in 1993.

Rising unemployment became a political burden for a socialist government. However, Labour considered reduction of the public deficit its main task, although claiming that its fiscal strategy was fairer than that of the earlier non-socialist coalition. The objective of austerity was partly to prevent overheating in 1996-7, but primarily to reduce long-term interest rates by deflecting expectations — in international capital markets — of increasing Swedish inflation. Also the Central Bank shared this expectation, which raised the short-term interest rate in the Winter of 1994-5. The

[29] The lack of renewal and productivity growth in Sweden's established manufacturing firms during the 1980s also explains a lot of the 1990s rise in productivity. Many firms were unprepared for a situation of declining demand and increasing foreign competition. Rationalisations that should have been started in the 1980s, started only first in the early 1990s. The decline in demand was matched by a stronger decline in employment, and thus by exceptional productivity increased by established firms.

[30] The Rehn-Meidner model had been associated with Labour, and it is thus a paradox that the *Only Way* in fact resembled that model in many respects: tight economic policies to reduce inflation and promote growth, with labour market policy securing full employment. However, the Rehn-Meidner model was formulated for an overheated economy, not for a recession situation, it emphasised redistribution and full employment more strongly, and had more room for selective instruments.

[31] It was still expansive, albeit less so than in 1992. However, here we must once again emphasise that the Rehn-Meidner model is mainly a model for an «overheated» situation. Reformulated for a high unemployment situation, the model justifies more expansive fiscal and monetary policies than those of Sweden 1993/4.

Central Bank had not been able to prevent the Swedish long-term rates from rising clearly above the German rates in 1994. Extensive labour market programmes but could not prevent a rapid rise in unemployment, as these programmes were not supported by other fiscal policy instruments.

Critics claimdd that the net effects on employment and inflation will be minor, since the program coincided with high average profitability due to devaluations and earlier reductions in general payroll taxes. But to some extent, Sweden did pursue a stabilisation policy. While the ambition may have been to tighten policies, the result was expansion. Despite cuts, the discretionary element in fiscal policy still generated expansion, and one of the main reasons must have been the generous help granted to the banks. However, the passive growth policy lived on. The combination of traditional infrastructural investments and tax relief, as well as the devaluation, would above all favour the traditional industrial core of the Swedish model. In contrast, r&d spending (real terms) was reduced by the government. It seems that the Swedish growth strategy is the same irrespective of all declarations of a «new» industrial structure to promote SMEs.

In Denmark, the orientation towards EU increased as a consequence of the anticipation of the internal market in the late 1980s. There was increasing industrial competition from the EU and for that sake, from the whole OECD-area. While in the mid-1980s, there had been talk about the «vanishing productivity», productivity growth in Denmark picked up since the late 1980s. Increasing competitive pressure tended to destroy old firms more easily than it led to new activities.

The routines in the new Danish model are: A hard currency exchange rate policy (EMS-link), and consequently no monetary policy; incomes policies (informal «negotiated economy») leading to wage-growth below the main competitors. It is accepted that external debt and the current account sets limit to fiscal policies. (But there has been a slight change of fiscal policy, a bit more active since 1993). Altering the exchange rate policy was out of question due to EU-membership. There seems to be no great controversy on any element of Danish economic policies: A return to devaluations seems impossible. Danish monetary policy is still — like in the Dutch case — heading for a quite close link to the «old» parity with the DEM. High unemployment was explicitly accepted. Incomes policies lead to below average wage growth despite a decentralisation (not to the firm level, but to 6 negotiation cartels, instead of LO/DAF-level).

This present Danish model recognises that there are limits to macro policies in an internationalised economy.[32] Within these limits, there is consensus on certain goals: welfare goals, equality goals, and tackling of the balance problems. As compensation it opts for structural policies in the areas of the labour market and industry.

In 1992, Iceland's currency basket was reduced to three currencies only (USD, ECU, YEN). There was no disagreement in parliament on this principle, but the timing was critisized. In order to soften the credit squeeze on the fisheries sector without falling back on the devaluation routine, the government payed back prior in-payments to the equalisation funds. The new regime, however, will only be sustainable if wage-earners are ready to adjust real wages sufficiently downwards when national income (particularly the share deriving from the fisheries) suffers shocks. Exchange rate depreciation within the ECU margins can hardly serve this role.

[32] Limits is here only a proxy for routine. They legitimate it as borders, but they are routines. There is fumbling in structural policies.

Conclusions

We find three cases of continued fumbling through the 1980s and early 1990s: As for Norway, our conclusion is that if there was a Golden Age model, there has not been anything so stable since 1973. There has been sequences of fumbling, stability has just been sectoral. This goes for Iceland and Sweden too. Sweden's Third Way was replaced by norm-based policy, but even that broke down, lasting shorter than one business cycle.

As for coherent economic policy models, we find two: Finland avoids the first two disappointments, maintaining a constellation of coherent regimes through its "Scandinavian" period from the early to the late 1980s. Presently, since the onset of crisis in Finland, only one coherent model remains, namely the Danish one. This cluster of routines was established 1982-87, and still proves reasonably coherent. It involves, however, a high rate of unemployment. We shall not here approach the discussions of how high Denmark's unemployment really is. (It has been argued that it is not as high, since until recently, Denmark had not paid maternity leave, and furthermore, than there is a group of permanently marginalised people, so to say a lost generation, that should n o longer be included in the unemployment rate. In addition, it is argued that Denmark's unemployment compensation system remains among the most generous in the world.)

We have seen that Denmark is the leading Nordic country through the last period. Given that unemployment has reached a higher level in all the countries, they need to learn from Denmark in that respect too, since Denmark is an avant garde in work sharing arrangements.

Throughout the last period we discussed, two more Nordic countries joined Denmark as members of EU. Negotiations for all the Nordic applicant countries started in 1993, and agreement was reached in March 1994. Referenda took place in 1994: in Finland on October 16, Sweden on November 13, and in Norway on November 28. All except Norway voted yes to membership.

Politically, social democracy has returned in four of the five countries. As for executive power, Norway had a Labour minority government since late 1990. Iceland and Finland had various centre/right coalitions. Denmark (to 1993) and Sweden (1991-4) had non-socialist coalitions. By the mid-1990s, however, in all countries except Iceland, Labour proved to dominate. In Norway, the Brundtland government was unchallenged even after losing the EC-referendum in 1994. In Denmark (1993), Sweden (1994), and Finland (1995), Labour regained executive porwer. In the Danish and Finnish cases, various Labour-dominated coalition governments ruled. As none of the Labour parties enjoyed majority positions in parlament, the Swedish and Norwegian governments were minority governments.

We have loosely indicated the coming of a third version of neoliberalism, namely the europeanized version. The present situation is of course ambiguous and may turn in various directions. One likely direction, however, is related to the fact that now three out of the five countries have become EU-members. If emphasis on the EMU convergence criteria continue to determine economic policies, we can envision such an *EU-based,* or *europeanized neoliberalism.* The ambiguity of the situation, however, lies in the fact that EU's EMU-project in itself has encountered several setbacks since the European currency crises in 1992 and 1993. (This external disappointment was just briefly mentioned above, but it is of course more thoroughly discussed in the project's final report.) In any case, the developments in the mid-1990s merit the conclusion that the future of economic policies in the Nordic area, and possibly also of the social democrats who influence these policies, are strongly dependent now on the fate of the EU-project.