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Note: This article "International financial crisis and the Swedish economy 1857-1933", pp. 254-64 in F. Capie and G. Wood, eds., *Financial Crises and the World Banking System*, MacMillan 1986, London, is a comment to Michael D. Bordo "Financial crises, banking crises, stock market crashes and the money supply: Some international evidence, 1870-1933", chapter 6 in the same volume.

International Financial Crisis and the Swedish Economy 1857–1933[1]

LARS JONUNG

'The London money market is the biggest in the world, the smaller exchanges rotate around its axis as the planets around the sun, and it is no wonder that the phenomena, which appear simple and easy to understand from the center, appear mysterious and complicated, when regarded from the periphery.'

Quoted from I. Heckscher: 'Om växelkurserna i Sverige' (On foreign exchange rates in Sweden). Postscript to the Swedish translation of G. Goschen, *Läran om utländska växelkurser*, Stockholm, Nordstedt, 1892.

INTRODUCTION

How were financial crises transmitted from one country to another in the period 1870–1933? What were the effects of financial crises on economic activity? Michael Bordo answers these two questions by making a distinction between two approaches to the international transmission of financial crises: (a) the monetary approach and (b) the Fisher–Kindleberger–Minsky 'real' approach. A number of testable implications are derived and examined by studying the international covariation between various monetary and financial aggregates and ratios during the whole period 1870–1933, during NBER reference cycle contractions, and during NBER reference cycle expansions. Six countries are included in this very ambitious investigation, namely the United States, Great Britain, Germany, France, Canada and Sweden.

Canada and Sweden are viewed as countries on the periphery of the world financial centres of London, New York, Paris and Berlin.

My comment is based on an examination of the Swedish record focusing on Swedish–British developments. My aim is to study how and to what extent foreign financial crises influenced the Swedish economy. First, I describe the Swedish institutional setting. Then I study the domestic impact of a large number of international financial crises. Finally, I compare my conclusions with those of Bordo.

THE INSTITUTIONAL SETTING

An account of how Swedish monetary and financial markets were linked to international ones during the pre-1914 gold standard may throw light upon the international transmission mechanism of financial crises.

International Financial Connections

The histories of Sweden's major commercial banks during the gold standard (*the Stockholms Enskilda Bank, Skandinaviska Kreditaktiebolaget* and *the Handelsbank*) show that these banks had very close international connections. They held accounts (credit lines) with major banks or bankers in a number of foreign financial centres, in particular in London, Hamburg, Berlin and Paris. Another commonly used way of obtaining reserves from abroad was by the discounting of bills, both foreign and domestic. Major commercial banks also held bonds which were easily saleable on foreign financial markets. They were active in long-term borrowing from abroad as middlemen between foreign investors and the Swedish Government, Swedish local authorities and Swedish companies. Financial institutions other than commercial banks were also engaged in international financial intermediation. To sum up, Swedish money and capital markets were closely tied to the English, French and German markets.

While London and Paris were reserve centres for the major Swedish commercial banks, they in turn functioned as lenders-of-last-resort for regional domestic banks. Furthermore, the *Riksbank* and the National Debt Office were also engaged in international financial transactions. Gradually, these institutions developed into lenders-of-last-resort ready to carry out offsetting operations in case of foreign disturbances.[2]

International Trade

Sweden was tied to the international economy through international trade. Exports and imports represented roughly 20 per cent of GDP in the period 1871–1914. As the Swedish economy was an open one, the international business cycle determined the Swedish one. Table 6.3, displaying the troughs and peaks of the British and Swedish business cycles in 1868–1909, shows a near-perfect cyclical covariation between the two countries. Fluctuations in Swedish exports were thus a most important channel of transmitting foreign cyclical variations.

TABLE 6.3 BRITISH AND SWEDISH BUSINESS CYCLES 1869–1909

		Trough	*Peak*	*Trough*
1.	British cycle	1868	1872	1879
	Swedish cycle	1868–9	1874–5	1878–9
2.	British cycle	1879	1882	1886
	Swedish cycle	1878–9	1884	1887
3.	British cycle	1886	1890	1894
	Swedish cycle	1887	1890	1892–3
4.	British cycle	1894	1900	1901
	Swedish cycle	1892–3	1900	1901
5.	British cycle	1901	1907	1908
	Swedish cycle	1901	1907	1909

Source: British cycles dated by Burns and Mitchell (1946). Swedish cycles dated by Jörberg (1961) using the NBER reference cycles method. His dating is based on the cyclical behaviour of between 96 and 180 time series combined with non-statistical information on the activity of Swedish industry. Jörberg is more certain about the dating of troughs than of peaks.

To the extent that a British financial crisis influenced the British economy, reducing real activity, there are reasons to believe that a British contraction would reduce Swedish exports and thus reduce real output in Sweden.

A foreign financial crisis could thus be transmitted to Sweden in two major ways:

(a) through financial markets, directly reducing the supply of foreign finance, and thus the Swedish monetary base and money supply, as well as raising interest rates;
(b) through markets for goods and services reducing the demand for Swedish exports.

DOMESTIC EFFECTS OF FOREIGN FINANCIAL CRISES

To investigate the domestic effects of foreign financial crises, I have used the crisis chronology found in Åkerman's (1944) account of business cycles in the United States, Britain, Germany and France between 1820 and 1940. By combining his narrative with other evidence for Sweden, the following general picture emerges.

Pre Gold Standard Period 1857–72

Prior to the introduction of the gold standard in Sweden, three major foreign financial panics occurred, that is in 1857, 1864 and 1866. They caused rises in interest rates in Sweden and reduction in the money supply, in particular in 1857–8 as the *Riksbank* responded by calling in loans when its silver holdings were reduced due to foreign demand. There were no major effects on domestic economic activity during these crises, the main reason being that Sweden was primarily an agricultural economy. The monetary sector and the export sector encompassed such a small share of the domestic economy that the aggregative effects of the financial disturbances were minor.[3]

The Gold Standard 1873–1914

A foreign financial panic generally had the following two effects on Swedish money and capital markets: interest rates tended to rise and commercial banks experienced 'difficulties' in obtaining foreign finance. Commercial banks compensated for the reduction in foreign reserves in various ways; by borrowing from the *Riksbank*, by selling bonds and by discounting bills abroad. The monetary authorities usually took measures to offset the drain on foreign reserves by borrowing from abroad and by lending at home.

This stylised description holds good for the 1890 Baring Brothers crash and the 1907 crisis. It does not hold for all foreign panics. Several of them did not have any noticeable impact on Swedish money and

capital markets, for example the 1873 crises in Austria, Germany and the USA, the 1882 crisis in France, and the stock market crash in Paris 1889 (see Table 6.4).

Considering the impact of financial crises on domestic economic activity, it is difficult to separate the effects of such crises from the effects of the general business cycle. One financial crisis occurred during a recession, i.e. in 1878–9. Others took place in the midst of or at the end of a boom, i.e. in 1873 and 1907, having practically no impact on Swedish developments (see Table 6.4).

The evidence suggests that foreign financial crises had as a rule no significant separate and lasting effects on the Swedish economy during the gold standard prior to 1914. These crises were of short duration, thus not reducing the domestic activity in the country of origin to such an extent that Swedish exports were critically reduced. Furthermore, the *Riksbank* engaged in offsetting operations reducing the impact of foreign monetary disturbances. Nor were financial crises prior to 1914 a major threat to the international financial system.

The gold standard before 1914 was thus associated with such stability, including expectations of stability, that financial panics tended to be of fairly short-lived and consequently of minor economic importance compared to the experience of the post-First World War gold standard.

Interwar Period 1919–33

The interwar period was drastically different from the pre-1914 gold standard. Long-lasting deep depressions with large unemployment characterise the 1920s and 1930s. The world financial system functioned badly. There was general uncertainty about the workings of the monetary regimes and the exchange standards compared to the situation prior to the First World War.

To the extent that the depressions of the 1920s and 1930s were caused by monetary and financial disorder, one can argue that domestic activity was influenced by international financial problems. However, there were no specific foreign financial crises that spread to Sweden. Notably, the stock market crash of 1929 in the US did not influence Sweden directly. Rather, the international downturn in economic activity exerted a strong influence on the domestic economy starting in late 1931.

The policy of the *Riksbank* played a much larger role in determining economic outcomes in the interwar period than during the pre-1914

TABLE 6.4 FOREIGN CRISES AND DOMESTIC DEVELOPMENTS 1857–1932

Date (1)	Foreign crises City (Countries) (2)	Domestic developments (3)
Oct–Dec 1857 Nov 1857	Britain Germany, Continent	– trade crises, default of merchant houses,[1] increase in interest rates, Swedish government borrows in Hamburg,[2] no major effect on Swedish economy.
May 1864	Paris,[3] London	– increase in interest rates, "lack of money", no major effect[4]).
May 1866	London, Overend, Gurney crash	– no crisis in Sweden, increase in domestic interest rates.
May 1873 Sept 1873	Germany/Austria USA	– no crisis in Sweden, boom in export industries.
Jan 1882	Lyon, Paris bank defaults	– no crisis in Sweden[5]
Spring 1889	Paris, Panama Company-crash.[6]	– no effect on Sweden.
Nov 1890	London, Baring crash	– no crisis in Sweden, interest rate increases.
May 1893	USA	– no crisis in Sweden.
Aug 1907 Oct 1907	France, Italy US Bank runs	– no financial crisis in Sweden, increase in interest rates, depression.
Aug 1914	outbreak of war	– Sweden leaves the gold standard.
1920–1	post-war depression	– post-war depression, financial 'distress', default of some minor banks, no panics, large unemployment.
Oct 1929	US stock market crash	– no crisis in Sweden, 1929 a boom year.
May–June 1931	Austria–Germany bank panics	– no financial crisis in Sweden.
Sept 1931	Britain leaves gold	– Sweden leaves gold.
1932–3	worldwide depression	– death of Ivar Kreuger, financial 'distress', large unemployment.

Source: Åkerman (1944: 247–552)
Kindleberger (1978: 253–9)

Notes: [1] Hedlund–Nyström (1970).
[2] Åkerman (1944: 318) notes that the crisis of 1857 is the first 'modern' international crisis, in the sense that the industries of the Continent were now linked to UK and US business cycles through the rise of an international money market.
[3] Minor stock exchange crises.
[4] Hedlund–Nyström (1970: 190).
[5] Åkerman (1944: 368).
[6] Åkerman (1944: 387).

gold standard. Basically, the monetary authorities had the choice of maintaining a fixed exchange rate for the *krona* to gold (or to any other international reserve currency) or of allowing the exchange rate to fluctuate. In the first case, foreign disturbances were directly imported through the fixed rate. In the second case, flexible rates could insulate Sweden from foreign disturbances, at least partially.

In the early 1920s, the *Riksbank* decided to return to gold at the pre-war parity. This decision caused a large deflation and as a consequence widespread unemployment, actually larger than in the 1930s. The depression of the 1920s was thus to a large extent caused by domestic measures. Sweden was the first country in Europe to return to the gold standard after the First World War.

Sweden remained on gold until the early 1930s. The *Riksbank* decided to leave the gold standard in September 1931, shortly after the Bank of England had taken the same step, and devalued the Swedish currency substantially. Domestic price stabilisation was announced as the official goal of Swedish monetary policy. This monetary regime managed to isolate Sweden from the depression compared to the case of countries that stayed on a fixed rate to gold longer than Sweden.[4]

Crises of Domestic Origin

A few crises originated primarily within Sweden during the period covered. One such crisis occurred in 1868–9 due to harvest failures. The death of Ivar Kreuger in 1932 started a domestic financial crisis. However, the Government, the *Riksbank*, and other banks intervened, thus mitigating the effects of the default of the Kreuger empire. Generally, the Swedish monetary sector displayed considerable stability during the period 1856–1933. The sources of disturbances were as a rule of foreign – not of domestic – origin.

Conclusions

The above account of the transmission and effects of foreign financial crises suggests the following conclusions.

1. Foreign financial crises did not have any major and lasting influence on the Swedish economy prior to 1914. One reason was that they were of a short-run character. Another was that the pre-1914 gold standard regime functioned such that financial crises did not develop into major international disturbances.

2. The international business cycle exerted the major influence on domestic economic events.
3. The initial impacts of foreign financial crises were registered on Swedish financial markets, raising interest rates and reducing lending from abroad. These effects, however, did not spread to such an extent that they exerted by themselves a significant influence on the domestic economy.
4. The experience of financial as well as of real disturbances in the 1920s and 1930s is radically different from the experience of the pre-1914 gold standard. The disturbances emanating from abroad were much larger in the interwar period than before 1914. These differences were due to the absence of a stable international monetary regime. The occurrence of financial instability in this period was a reflection of this state of affairs.[5]

A COMPARISON WITH BORDO'S RESULTS

Bordo presents three conclusions. First of all, he stresses the 'important role of monetary institutions'. I am in complete agreement with him on this account. The conduct of monetary policy, in particular the existence of a lender-of-last-resort, determined to what extent foreign financial disturbances were transmitted into Sweden. The stability of the monetary regime should also be stressed. The pre-1914 gold standard was associated with a stable international financial system compared with the post-1918 experience. Within Sweden, the legal framework of the commercial banking system fostered stability and public trust in the solvency of the banks. As rightly pointed out by Bordo, the US experience of banking panics appears as 'an historical curiosity in other countries'.

Secondly, Bordo concludes that movements in the deposit–reserve ratio of the commercial banking system may have been important in the international transmission of crises. He suggests a link between the stock market and the commercial banking system. The Swedish stock market, however, was not well developed prior to 1914. Rather, I should like to stress another link involving the commercial banking system – that is the link between commercial banks in the periphery borrowing from the reserve centres in London, Paris and Berlin in a way similar to the US system, where regional banks were financially connected to the New York banks.

Let me develop this view further. Bordo presents a domestic and an international version of the monetarist approach to the transmission of financial crises. The domestic version stems from US monetary history where New York City banks were the reserves for US regional banks. When facing bank runs and panics, regional banks were dependent on financial support from the centre. Movements in the reserve ratios of the US commercial banking system thus reflected financial crises and the conduct of monetary policy. According to Bordo, the international version of the monetarist approach stresses gold and capital flows as the primary mechanism for transmitting crises internationally. Thus, he tests for cross-country covariation between money supply and gold stocks to investigate the explanatory power of the monetarist approach. In my opinion, the international version of the monetarist approach should be closely combined with the domestic version when examining how financial crises spread internationally.

Bordo's third and final conclusion is that the cross-country correlations 'provides support for the monetarist theory of the international transmission of financial crises although evidence for linkages through bank portfolios in times of crises stressed by the real approach was also found'. I have a few comments on these tests. It is difficult to separate the influence of general business cycle developments from the effects of financial crises. The empirical results tends to be tests of the international transmission of the business cycle, in particular as some financial crises did not spread internationally.

The spread of financial crises through the balance of trade is not explicitly dealt with in the tests. Bordo's comparison between two approaches, the monetarist and the 'real' view, focuses most of his interest upon monetary and financial variables possibly at the expense of the role of the balance of trade. Judging from the Swedish experience, its seems promising to explore how a financial panic spreads (a) through money and capital markets and (b) through 'real' channels. My preliminary conclusion is that the initial impact came through financial channels and the second-round effects through the balance of trade, in particular in the case of a serious foreign financial crisis.

Furthermore, I am of the opinion that it is difficult to find readily testable implications of the 'real' approach of Fisher–Kindleberger–Minsky. Kindleberger's (1978) description is on such a general level that I do not perceive any clear testable implications. I suspect that Bordo has tried hard to construct a 'worthy' counter-hypothesis to the monetarist interpretation. In the process, the Kindleberger approach is made a stronger challenger than it actually deserves to be. In any case, I

think the term 'real' should be used for the transmission of financial crises through international trade, not through financial markets.

Let me sum up my reading of the Swedish record and of Bordo's results. International financial panics under a fixed and stable system of exchange rates, as the case was during the pre-1914 gold standard, did not cause *per se* major domestic disturbances. They spread initially through financial markets (money and capital markets). When they were severe, generally in connection with a downturn of international economic activity, the domestic economy may also have been influenced. These crises were often mitigated by an offsetting domestic monetary policy.

During the interwar period, two deep depressions influenced the world economy. They were associated with a general uncertainty concerning the prevailing monetary regime as well as with large financial disturbances. Eventually, the international financial system broke down. The interwar period should be classified as a crisis for the international financial system.

A comparison between the pre-1914 gold standard and the interwar period suggests that financial panics occurring in one or several countries do not cause major problems in a stable monetary system. However, a crisis for the whole monetary system, 'the whole regime', threatens the foundations of international finance and trade and thus of economic growth and prosperity. This seems to be a valuable lesson for today.

NOTES

1. I have received valuable comments from Michael Bordo, Lennart Jöberg and Torun Hedlund-Nyström. Richard Brooks improved my English.
2. The offsetting policy of the *Riksbank* is described in Jonung (1984).
3. On this point see Hedlund-Nyström (1970).
4. See Jonung (1979).
5. This argument is forcefully presented by Cassel (1936).

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